United Nations A/CN.9/WG.V/WP.58

General Assembly

Distr.: Limited
5 October 2001

Original: English

United Nations Commission on International Trade Law
Working Group V (Insolvency Law)
Twenty-fifth session
Vienne, 3-14 December 2001

Draft legislative guide on insolvency law

Report of the Secretary-General

Contents

[The Introduction, Part One and Part Two I of the draft Guide appear in document A/CN.9/WG.V/WP.57]

		Paragraphs	Page
II.	Application for and commencement of insolvency proceedings	1-39	3
	A. Scope of the insolvency law	1-9	3
	1. General remarks	1-9	3
	2. Summary and recommendations-scope	--	5
	B. Application and commencement criteria	10-39	6
	1. General remarks	10-39	6
	2. Summary and recommendations-applicatrion and commencement	--	14
III.	Consequences of commencement of insolvency proceedings	40-151	15
	A. The insolvency estate	40-52	15
	1. General remarks	50-52	15
	2. Summary and recommendations-insolvency estate	--	18
	B. Protecting the insolvency estate	53-83	19
	1. General remarks	53-83	19
	2. Summary and recommendations-protecting the insolvency estate	--	26

V.01-87672

	C. Treatment of contracts	84-123	27
	1. General remarks	84-123	27
	2. Summary and recommendations-treatment of contracts	--	36
	D. Avoidance actions	124-151	37
	1. General remarks	124-151	37
	2. Summary and recommendations-avoidance	--	43
IV.	Administration of proceedings	152-252	45
	A. Debtor's rights and obligations	152-170	45
	1. General remarks	152-170	45
	2. Summary and recommendations-debtor's rights and obligations	--	49
	B. Insolvency representative's rights and obligations	171-186	50
	1. General remarks	171-186	50
	2. Summary and recommendations-insolvency representative's rights and obligations	--	54
	C. Post-commencement financing	187-191	55
	1. General remarks	187-191	55
	2. Summary and recommendations-post-commencement finance	--	57
	D. Creditor committees	192-212	57
	1. General remarks	192-212	57
	2. Summary and recommendations-creditor committees	--	61
	E. Claims of creditors and their treatment	213-252	62
	1. General remarks	213-252	62
	2. Summary and recommendations-creditor claims	--	71
V.	Liquidation and distribution	253-260	72
	A. Distribution priorities	253-255	72
	1. General remarks	253-255	72
	2. Summary and recommendations-distribution	--	72
	B. Discharge	256-260	73
	1. General remarks	256-260	73
	2. Summary and recommendations-discharge	--	74
VI.	Reorganization plans	261-299	74
	1. General remarks	261-299	74
	2. Summary and recommendations-reorganization plans	--	83

II. Applications for and commencement of insolvency proceedings

A. Scope of the insolvency law

1. General remarks

(a) Debtors to be covered by an insolvency regime

1. An important threshold issue in designing a general insolvency regime is determining which debtors can be subjected to the law. To the extent that any debtor is excluded from the process, it will not enjoy the protections offered by the process, nor will it be subject to the discipline of the process. The eligibility provisions will identify the types of debtors whose businesses may be liquidated or reorganized and any businesses that are to be excluded from the application of the law. This raises the question of whether the law should distinguish between individual debtors and debtors which are commercial entities, each of which will raise not only different policy considerations, but also social and other attitudes. Policies towards individual or personal debt and insolvency often evidence cultural attitudes that are not as relevant to commercial debtors. They include attitudes toward the incurring of personal debt; the provision of relief for unmanageable debt; the effect of bankruptcy on the status of individuals; and providing for discharge from debts and claims. Policies applicable to the insolvency of commercial entities will be based, in comparison, on economic and commercial considerations such as the important role that those entities play in the economy and the need for those considerations to be reflected in the applicable insolvency procedures.

2. For these reasons, the insolvency law may need to consider drawing a distinction between the different types of entities involved in commercial business activities and indicating into which branch of insolvency law (personal or commercial) individual or personal business activities (including, for example, partnerships of individuals and sole traders) will fall. Different tests may be developed to facilitate that determination, such as focussing upon the nature of the activity being undertaken, the level of debt and the connection between the debt and the business activity. However, the experience of a number of countries suggests that although individual business activities form part of commercial activity, such cases often are best dealt with under the regime for individual insolvency because ultimately the proprietor of a personal business [unincorporated business] is personally liable without limitation for the debts of the business. Those cases also raise difficult issues of discharge (release of the debtor from liability for part or all of certain debts after the conclusion of the proceedings) and attachment of post-insolvency wages, as well as personal matters such as settlements in divorce proceedings. Additionally, the inclusion of such individual insolvency within the commercial insolvency regime has the potential to hinder the application of that regime because of a general perception of the undesirability of insolvency. It is desirable that these concerns be considered in designing an insolvency law to address business insolvency. This Guide does not address those distinctions but focuses upon the conduct of trade and business, irrespective of the vehicle through which the business activities may be conducted.

3. A general insolvency regime can apply to all forms of entity engaged in business activities, both private and state-owned, especially those state-owned enterprises which

compete in the market place as distinct commercial or business entities and are otherwise subject to the same commercial and economic processes as privately-owned entities. Government ownership of an enterprise may not, in and of itself, provide a sufficient basis for excluding an enterprise from the coverage of the general insolvency law. Inclusion of these entities has the advantages of subjecting them to the discipline of the market place and sending a clear signal that government financial support will not be unlimited. An exception to a general policy of inclusion may arise where the government has adopted a policy of extending an explicit guarantee in respect of the liabilities of such enterprises. In cases where the treatment of state enterprises is part of a change in macroeconomic policy, such as large-scale privatization programs, independent legislation dealing with relevant issues, including insolvency, may be warranted.

4. Although it may be desirable to extend the protections and discipline of an insolvency regime to as wide a range of entities as possible, separate treatment may be provided for certain entities. That special treatment may be desirable, for example, on the basis of public policy concerns, in the case of consumers. It may also be desirable in the case of certain entities of a specialized nature, such as banking and insurance institutions, utility companies, and stock or commodity brokers because of the detailed regulatory legal regimes to which they are often subject. The special considerations arising from the insolvency of such entities are not specifically addressed in this Guide.

(b) Applicability of the insolvency law

(i) Centre of main interests

5. In addition to embodying the necessary business attributes, a debtor must have a sufficient connection to the host State to be subject to its insolvency laws.

6. Although some insolvency laws use tests such as principal place of business, UNCITRAL has adopted, in the Model Law on Cross-Border Insolvency ("the UNCITRAL Model Law"), what is termed the "centre of main interests" of the debtor to determine the proper location of the "main proceedings" for that debtor. In addition to the UNCITRAL Model Law, that term is used in the [draft] UNCITRAL Convention on the Assignment of Receivables in International Trade and in the Council (EC) Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings ("the EC Regulation"). The UNCITRAL Model Law does not define the term; the EC Regulation (13th Recital) indicates that the term should correspond to "the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties." An appropriate test would be that provided in article 16 (3) of the UNCITRAL Model Law and article 3 of the EC Regulation: the debtor's registered office, or habitual residence in the case of an individual, is presumed to be the centre of main interests, unless it can be shown that the centre of main interests is elsewhere. A debtor which has the centre of its main interests in a State should be subject to that State's insolvency law.

7. Notwithstanding the adoption of the "centre of main interests" test, a debtor which has assets in more than one State may find itself satisfying the requirements to be subject to the insolvency law of more than one State because of the different tests of debtor competency or different interpretations of the same test, with the possibility of separate insolvency proceedings in those countries. In such cases, it will be appropriate

to have in place legislation based on the UNCITRAL Model Law to address questions of coordination and cooperation.

(ii) Establishment

8. Some laws provide that insolvency proceedings may be commenced in a jurisdiction where the debtor has an establishment. The term "establishment" is defined in article 2 of the UNCITRAL Model Law to mean "any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services." Article 2 of the EC Regulation includes a similar definition but omits the reference to "services". Essentially then, an establishment is a place of business but not necessarily the centre of main interests. The definition is important to the overall structure of the UNCITRAL Model Law as it determines those proceedings that may be recognized only as non-main proceedings; main proceedings require the presence of a centre of main interests. The EC Regulation similarly provides that secondary insolvency proceedings may be opened in a jurisdiction where a debtor has an establishment, but that those proceedings will be restricted in their application to the assets of the debtor situated in the territory of that State.

(iii) Presence of assets

9. Some laws provide that insolvency proceedings may be commenced by or against a debtor that has assets within the jurisdiction or has had assets within the jurisdiction without requiring an establishment or centre of main interests within the jurisdiction. In this regard a distinction should be made between liquidation and reorganization proceedings; while presence of assets may be an appropriate basis for commencement of liquidation proceedings involving the assets located in that State, it would not be sufficient to justify commencement of reorganization proceedings. The test of presence of assets potentially raises multi-jurisdictional issues, including multiple proceedings and questions of co-ordination and co-operation between proceedings that may implicate the UNCITRAL Model Law.

2. Summary and recommendations-scope

(1) The purpose of provisions on scope of the insolvency law is to determine:

(a) which debtors can be subject to the insolvency law;
(b) which debtors require specialized treatment and should therefore be covered by a specialized insolvency regime and excluded from the general regime;
(c) criteria for commencement of insolvency proceedings in the enacting State.

(2) An insolvency law should govern insolvency proceedings of all [debtors] [corporate or commercial entities] engaged in business activities [including State-owned enterprises engaged in [business][commercial] activities].

(3) Banks, insurance companies and other specified entities which are subject to special regulation and a specialized insolvency regime may be excluded from the application of the general insolvency law.

(4) Insolvency proceedings may be commenced by or against a debtor if the debtor has its centre of main interests in the enacting State.

(5) In the absence of proof to the contrary, a legal person is presumed to have its centre of main interests in the State in which it has its registered office.

(6) In the absence of proof to the contrary, a natural person is presumed to have its centre of main interests in the State in which it has its habitual residence.

(7) Liquidation proceedings may be commenced by or against a debtor if the debtor has an establishment in the enacting State, but those proceedings should be limited to the assets of the debtor situated in that State.

B. Application and commencement criteria

1. General remarks

10. Application and commencement criteria are central to the design of an insolvency law. By providing the basis upon which an application for the commencement of insolvency proceedings can be made, these criteria are instrumental to identifying the entities that can be brought within the protective and disciplinary mechanisms of the insolvency process and determining who may make an application.

11. As a general principle it is desirable that access to the insolvency process be convenient, inexpensive and quick in order to encourage financially distressed or insolvent businesses to voluntarily submit themselves to the process. It is also desirable that access is flexible in terms of the types of procedures available, the ease with which the procedure most relevant to a particular debtor can be accessed and conversion between the different types of procedures can be achieved. Restrictive access can deter both debtors and creditors from commencing procedures, while delay can be harmful in terms of its effect on the value of assets and the successful completion of the process, particularly in cases of reorganization. Ease of access needs to be balanced with proper and adequate safeguards to prevent abuse of the process. A debtor that is not in financial difficulties may apply for the commencement of insolvency proceedings in order to take advantage of the protections provided by the law, such as the automatic stay, not because it cannot pay its creditors in full and therefore requires the protections of the insolvency law. Creditors who are competitors of the debtor may take advantage of the process to disrupt the debtor's business and thus gain a competitive edge.

12. Laws differ on the specific criteria that must be satisfied before the proceedings can commence. A number of laws include alternative criteria, and distinguish between the criteria applicable to commencement of liquidation and reorganization proceedings, as well as between applications by a debtor and a creditor.

(a) Liquidation

13. Insolvency laws generally provide for an application for liquidation proceedings to be made by the debtor (often described as voluntary proceedings), by one or more creditors (often described as involuntary proceedings) or by operation of law where the failure by the debtor to meet some statutory requirement automatically triggers insolvency proceedings (also described as involuntary).

14. A criterion that is used extensively for commencement of liquidation proceedings is the liquidity or cash flow standard which requires that the debtor has generally ceased making payments or cannot or will not be able to pay its debts as they become due. Reliance on this standard is designed to activate proceedings sufficiently early in the period of the debtor's financial distress to minimize dissipation of assets and avoid a race by creditors to grab assets that would cause dismemberment of the debtor to the collective disadvantage of creditors. Allowing commencement to take place only at a later stage when the debtor can demonstrate greater financial distress, such as balance sheet insolvency (when the balance sheet of the entity shows that the value of the debtor's liabilities exceed its assets), may only serve to interrupt the race by creditors that is already taking place.

15. One problem associated with the general cessation of payments standard—the commencement of liquidation proceedings in respect of an entity with only a temporary cash flow or liquidity problem—may be resolved by providing that the proceedings can be dismissed or converted to another proceeding (e.g. liquidation to reorganization—see ...). Other potential abuses of the process may be addressed by providing for the proceedings to be dismissed or converted, providing for sanctions to be imposed on a party that abuses the process or that the party improperly using the process should pay costs and damages to the other party. Actions attracting those measures may include a debtor using insolvency as a shield against a single creditor or as a means of prevaricating and depriving creditors of prompt payment of debts in full, or a creditor using the insolvency application as a substitute for debt enforcement procedures (which may not be well developed) or to attempt to force a viable business out of the market place or to obtain preferential payments.

16. The ways in which the general cessation of payments standard is used in insolvency laws vary. In some countries it provides the basis for commencement of either a liquidation or reorganization procedure and, where liquidation is chosen, it can later be converted to reorganization. In other countries, only a reorganization procedure may be commenced on the basis of this standard and the procedure may be converted to liquidation only when it is shown that the entity cannot be reorganized. Under a third approach, the standard is relied upon to commence a unitary procedure (see ...), and the choice between liquidation and reorganization is only made after a period of assessment.

17. An alternative to the general cessation of payments standard would be the balance sheet approach of excess of liabilities over assets as an indication of greater financial distress. This approach can be an inaccurate measure of insolvency where accounting standards and valuation techniques give rise to values that do not reflect the fair market value of a debtor's assets or where markets are not sufficiently developed or stable to enable that value to be established. Furthermore, as a test for commencement of insolvency it can lead to delay and difficulties of proof as an expert would generally be required to review books, records and financial data to reach a determination of the entity's fair market value. This is especially difficult where those records are not

properly maintained or readily available. For those reasons it often leads to proceedings being commenced after the possibilities of reorganization have disappeared. As a test for commencement of insolvency it is not necessarily meaningful to the debtor's ability to deal collectively with its creditors when the debtor maintains an operating business and it may also circumvent the objective of maximization of value. While the balance sheet approach may be used to assist in defining insolvency, for the reasons outlined above it may not be sufficiently reliable to constitute the sole basis of that definition.

(i) Debtor application

18. Many insolvency laws adopt the "general cessation of payments" requirement for debtor applications for liquidation. Where the standard is one of imminent insolvency, the ability to apply may be limited to the debtor. As a matter of practice, an application by a debtor will generally be a last resort where it is unable to pay its debts and the satisfaction of the criterion is often not strictly followed. That practice is reflected in some laws that allow debtors to make an application on the basis of a simple declaration of its financial condition (which in the case of a legal person may be made by the directors or other members of a governing body) without specifying any particular test of financial difficulty.

19. A matter related to debtor applications is the question of whether or not the debtor should have an obligation to make an application for commencement of proceedings at a certain stage of its financial difficulty. There is no widely agreed approach to the adoption of such a provision. In the case of liquidation, the imposition of such a duty may protect creditors' interests by preventing further dissipation of the debtor's assets and, in the case of reorganization, increase the chances of success by encouraging early action. Establishing such an obligation, however, may raise difficult practical questions of how and when it should apply, particularly where a delay in applying for formal proceedings could lead to personal liability of members of the debtor, its governing body or its managers. In those circumstances it may operate to discourage the debtor from pursuing alternative solutions to its financial difficulties, such as an out-of-court reorganization agreement, which may be a more appropriate alternative in particular cases. The adoption of incentives (such as protection from enforcement actions) may be a more effective means of encouraging debtors to initiate proceedings at an early stage.

(ii) Creditor application

20. Where the standard of general cessation of payments is adopted for creditor applications, problems of proof may arise. While creditors may be able to show that the debtor has failed to pay their own claim or claims, providing evidence of a general cessation of payments may not be so easy. There is a practical need for a creditor to be able to present proof, in relatively simple form, which establishes a presumption of insolvency on the part of the debtor, without placing an unreasonably heavy burden of proof on creditors. To refine the standard of general cessation of payments in order to establish a threshold of proof that creditors may satisfy, a reasonably convenient and objective test may be the failure of a debtor to pay a matured debt within a specified period of time after a written demand for payment has been made. However, creditors holding immature claims clearly have a legitimate interest in the commencement of insolvency proceedings. A particular concern may be in the case of holders of long-term debt who might never be eligible to seek commencement of proceedings where the test is one of maturity of debt, but whose debt may nevertheless be affected by the activities of the

debtor. However, developing a test that would allow such a creditor to make an application may raise difficult issues of proof, particularly in connection with the debtor's financial status. Where an insolvency law provides that applications may be made by creditors not holding mature debt, the issues of proof may need to be balanced against the objective of convenient, inexpensive and quick access.

21. Insolvency laws address the issue of creditor applications in a number of ways. Some laws require that the application be made by more than one creditor (which may be required to be an unsecured creditor which holds an undisputed claim); other laws require that the creditors hold mature claims and that they represent a specified composite value of claims (or a combination of both a specified number of creditors and a composite value of claims). A third approach requires (in the case of an application by a single creditor) that the debtor is to furnish information to the court that will enable it to determine whether the non-payment is the result of a dispute with the creditor or is evidence of a lack of liquid assets.

22. The rationale of requiring that more than one creditor make the application is often based upon the desire to minimise possible abuse by a single creditor who may seek to use the insolvency process as a substitute for a debt enforcement mechanism, particularly where the debt in question is small. That concern may need to be balanced, however, against the objective of facilitating quick and easy access to the insolvency process. Furthermore, the concern may be addressed by taking into account the value of the claim of the single creditor (although specifying a particular value for claims may not always be an optimal drafting technique since changes in the value of the currency may necessitate amendment of the law) or adopting a procedure like that outlined above which requires the debtor to provide information to the court. It can also be addressed by providing for certain consequences, such as damages for harm done to the debtor, where the creditor application is an abuse of the insolvency process.

23. Where the commencement criteria require that the claims of creditors be mature before an application can be made, some degree of flexibility may be desirable in order to cover exceptional circumstances where there is no mature claim, but insolvency proceedings should nevertheless be commenced. Those circumstances may include where there is evidence that the debtor is treating some creditors preferentially or where the debtor is acting fraudulently with regard to its financial situation and, in the case of reorganization, where proceedings are being commenced to implement a pre-negotiated arrangement.

(iii) Application by governmental authority

24. An insolvency law may give a governmental agency (normally the public prosecutor's office or the equivalent) or other supervisory authority non-exclusive authority to initiate liquidation proceedings against any entity if it ceases to make payments or, more broadly in some countries, if initiation is considered to be in the public interest. In the latter case, a demonstration of illiquidity may not be necessary, thus enabling the government to terminate the operations of otherwise healthy businesses that have been engaged in certain activities, for example, of a fraudulent or criminal nature. While the exercise of such police powers may be appropriate in certain circumstances, it is clearly desirable that they are not abused (such as by being regularly used) and that they are exercised in accordance with clear guidelines. The powers would generally only be available to commence liquidation proceedings, although there may be circumstances where liquidation could be converted to reorganization, subject to certain controls, such as

that the business activity is lawful and that management of the entity is taken over by an insolvency representative or governmental agency.

[A/CN.9/504, para. 35: Accordingly, the Working Group agreed that some criteria providing guidance as to the situations triggering that power and the manner in which it should be exercised, with a view to restricting the discretion of the relevant authority, should be provided.]

(b) Reorganization

(i) Debtor application

25. One of the objectives of reorganization proceedings is to establish a framework that will encourage debtors to address their financial difficulties at an early stage. A commencement criterion which is consistent with that objective may be one which does not require the debtor to wait until it has ceased making payments generally (i.e. wait until it is illiquid) before making an application, but allows an application in financial circumstances which, if not addressed, will result in a state of insolvency. Approaches to debtor applications vary between insolvency laws. In some laws, the reorganization procedure does not actually involve the application of any substantive criterion: the debtor may make an application whenever it wishes. Other laws, including those that have a unitary approach (see above ...), specify that the debtor may make an application if it envisages that, in the future, it will not be in a position to pay its debts when they come due.

26. It may be suggested that a relaxation of the commencement criteria could invite abuse of the procedure. For example, a debtor that is not in financial difficulty may apply to commence proceedings and submit a reorganization plan that is designed to allow it to shed onerous obligations, such as employment contracts or to prevaricate and deprive creditors of prompt payment of debts in full. Whether such abuse could arise is a question of how the elements of the reorganization procedure are designed including commencement criteria, preparation of the reorganization plan and debtor control of the business after commencement. Means of addressing possible abuse by the debtor could include providing in the insolvency law that the relevant court has the power to dismiss the application, or that the debtor should be liable to creditors for the costs associated with resisting the application and any damages for harm caused by it.

(ii) Creditor application

27. Although insolvency laws generally provide for liquidation proceedings to be initiated by either a creditor or a debtor, there is no consensus as to whether reorganization proceedings can also be initiated by a creditor. Given that one of the objectives of reorganization proceedings is to provide an opportunity for creditors to enhance the value of their claims through the continued operation and reorganization of the entity, it may be desirable that the debtor not be given exclusive authority to make an application. The ability of creditors to apply for reorganization is also central to the question of whether creditors can propose a reorganization plan (see Reorganization plan). A number of countries take the position that, since in many cases creditors are the primary beneficiaries of a successful reorganization, creditors should have an opportunity to propose the plan. If that approach is followed, it seems reasonable to provide that creditors can make an application for reorganization proceedings.

28. Where creditors can make an application for reorganization of the debtor, different views are taken as to the commencement criteria. One view of the commencement criteria is that applying the same standard to applications by creditors as applies in the case of debtor applications is difficult to justify. This is not only because of the difficulties associated with creditors being able to prove that a standard of prospective illiquidity has been met. It is also because, as a general matter, it would seem unreasonable for any form of insolvency proceeding to be commenced against the debtor's will, unless creditors can demonstrate that their rights already have been impaired. Commencement criteria could require creditors to demonstrate, for example, that ongoing cash will be available to pay for the day to day running of the business, that the value of the assets will support reorganization and that the return to creditors in a reorganization is likely to exceed the return in liquidation. One disadvantage of that approach is that it requires the creditors to have made, or be able to make, a thorough assessment of the business before making an application. To overcome the difficulties associated with creditors gaining access to relevant information, an insolvency law could provide, on the making of an application by creditors, for an assessment of the debtor's financial situation to be undertaken by an independent authority. Such a procedure may have the advantage of ensuring that proceedings are only commenced in appropriate cases, but care may be needed to ensure that the additional requirements do not delay commencement of the proceedings with consequences for maximization of value of the assets and the likelihood of successful completion of the reorganization.

29. The question of the complexity or simplicity of commencement standards is closely linked to the consequences of commencement and the conduct of the insolvency proceedings. In insolvency laws that apply a stay automatically on commencement of the proceedings, the ability of the business to continue trading and be successfully reorganized can be assessed after commencement. In other systems, that information may be needed before an application is made because th choice of reorganization presupposes that it will lead to a greater return to creditors than liquidation.

30. For those reasons, it may be appropriate to apply the same commencement criterion to applications by creditors for both liquidation and reorganization of the debtor (i.e. general cessation of payments - see above ...). Such a standard would appear to be consistent with both the two-track approach and the unitary approach (see above ...), where the application of a different commencement standard is not so much a function of the type of proceedings being initiated, but rather whether the applicant is the debtor or a creditor. The exception to the approach of having the same commencement criteria for both liquidation and reorganization would be those systems where either a debtor or creditor is precluded from initiating liquidation proceedings until it has been determined that reorganization is impossible. In that case, the commencement criterion for liquidation would not be general cessation of payments, but a determination that reorganization cannot succeed.

31. As in the case of liquidation proceedings, the criteria applicable to creditor applications for reorganization may include a requirement for the application to be made by a certain number of creditors or by creditors holding a certain value of matured claims, or both.

(c) Procedural issues

(i) The decision to commence insolvency proceedings

32. Insolvency proceedings raise a number of procedural issues. A preliminary point is the manner in which the proceeding is commenced once the application has been made. In many countries the normal practice is for a court of competent jurisdiction to determine, on the basis of the application for commencement, if the requisite conditions for commencement have been met. In some countries, that determination is also made by the appropriate administrative agency, where that agency plays a central supervisory role in the insolvency process. The central issue, however, is not so much who makes the decision to commence proceedings but rather what that body is required to do in order to reach its decision. Entry conditions which are designed to facilitate early and easy access to the insolvency process not only will facilitate the court's consideration of the application by reducing complexity and assisting it in reaching a decision in a timely manner, but also have the potential to reduce the cost of proceedings and increase transparency and predictability (see key objectives .....). The issue of cost may be of particular importance in the case of the insolvency of small and medium business entities.

33. Some insolvency laws draw a distinction between voluntary and involuntary applications. A voluntary application by a debtor may function as an acknowledgement of insolvency and lead to an automatic commencement of proceedings, unless it can be shown that the process is being abused by the debtor to evade its creditors. In the case of an involuntary application, the court is required to consider whether the commencement criteria have been met before making its decision. In other laws, irrespective of whether the application is voluntary or involuntary, the court is required not only to determine whether the entry conditions have been met, but also to assess the financial situation of the debtor to determine whether the type of proceedings applied for are appropriate to the particular circumstances of the debtor. One means of reducing the potential complexity of that assessment is to provide, firstly, for the assessment to be made after commencement where the court can be assisted by the insolvency representative and other experts and, secondly, for conversion between liquidation and reorganization. If the assessment to be made is complex and there is a potential for time delay between application and commencement, there is also the potential for further debts to be incurred in that period as the debtor continues to trade and may allow trade debts to increase to preserve cash flow.

(ii) Establishing a time limit for making the commencement decision

34. Where a court is required to make a decision as to commencement, it is desirable that that decision be made in a timely manner to ensure both certainty and predictability of the decision-making process and the efficient conduct of the proceedings without delay. One means of achieving those key objectives may be to provide a specified period of time after the making of an application within which the commencement decision must be made. Although that approach may serve the objectives of providing certainty and transparency for both the debtor and creditors, the achievement of these objectives needs to be balanced against possible disadvantages. A fixed time limit may be insufficiently flexible to take account of the circumstances of the particular case, it may establish an arbitrary time limit which takes no account of the resources available to the body responsible for supervision of the insolvency process or of local priorities, and it may prove difficult to ensure that the decision-making body adheres to the established limit. For these reasons, it is desirable that the insolvency law adopts a

flexible approach that emphasizes the advantages of quick decision-making and provides guidance as to what is reasonable, but also recognizes local constraints and priorities.

[Note to the Working Group: Is there any distinction between voluntary and involuntary applications in terms of timing for consideration by the court?]

(iii) Notice of commencement

35. Provision of notice of the commencement of insolvency proceedings is central to several key objectives of an insolvency regime – it ensures the transparency of the process and equality in the provision of information to creditors in the case of voluntary proceedings. Nevertheless, there may be exceptional circumstances where provision could be made, with the consent of the court, for notice to the debtor to be dispensed with on the basis that it may be impossible to provide or may thwart the purpose of a particular application.

36. In the event of a voluntary application by a debtor, creditors or other interested persons have a direct interest in receiving notice of the proceedings and an opportunity to dispute the presumptions of eligibility and insolvency (perhaps within a specified time period to prevent the proceedings from being prolonged unnecessarily). The question arises, however, as to the time at which creditors should be notified - on the making of the application or on commencement. The interests of creditors in knowing that the application has been made may need to be balanced, in certain circumstances, against the possibility that the position of the debtor may be unnecessarily affected in the event that the application is rejected or that creditors may be encouraged to take last minute action to enforce their claims. These concerns may be addressed by providing creditors to be notified on commencement of the proceedings.

37. In the event of an involuntary creditor application for insolvency proceedings, however, the debtor should be entitled to immediate notice of the application and should have an opportunity to be heard and to dispute the creditors' claims as to its financial position (see "Debtor's rights and obligations").

38. In addition to the question of the time at which notice should be given, an insolvency law may need to address the manner in which notice is provided and the information to be included in the notification to ensure that the notice is effective. The manner of providing the notice could address both the party required to give the notice (e.g. the court or the party making the application) and how the information can be made available. While notice may be provided directly to known creditors, for example, the need to inform unknown creditors has led legislators to include a provision requiring publication in an official government publication or a commercial or widely circulated national newspaper (see article 14, UNCITRAL Model Law on Cross-Border Insolvency). The information to be included in the notice may include the time for creditors to make claims, how and where those claims may be made and which creditors should make claims (i.e. whether secured creditors need to file a claim - see "Creditor claims").

(iv) Costs

[Note to the Working Group: should issues relating to costs be included in the Guide?]

39. Applications by both debtors and creditors for insolvency proceedings may be subject to the payment of fees. Different approaches may be taken to the level of fee imposed. One approach may be to set a fee that can be used to help defray the costs of the insolvency system. Where the resultant fee is high, however, it may operate as a deterrent and run counter to the objective of convenient, inexpensive and quick access to the insolvency process. A very low fee, on the other hand, may not be sufficient to deter frivolous applications and it is therefore desirable that a balance between these objectives be reached.]

2. Summary and recommendations-application and commencement

(1) The purpose of provisions in an insolvency law on application and commencement criteria is to:

(a) provide easy access to the insolvency law by insolvent debtors, creditors and government agencies;
(b) enable applications for insolvency proceedings to be made and dealt with in a speedy, efficient and inexpensive manner;
(c) facilitate access to the insolvency procedures that are most relevant to the debtor's financial situation;
(d) establish basic safeguards to protect both debtors and creditors from possible wrongful use of the insolvency law

(2) An application for liquidation proceedings may be made by:

(a) a debtor, in which case the debtor should show that it is or will be unable to pay its debts as and when they fall due [or that its liabilities exceed the value of its assets];
(b) one or more creditors that hold claims that are [mature and have not been paid by the debtor][presently due and owing]; or by one or more creditors that do not hold claims that are mature but who can show that the debtor [is or will be unable to pay its debts as and when they fall due [or that its liabilities exceed the value of its assets]];
[(c) a prescribed government or non-government authority on the basis of [...]].

(3) An application for reorganization proceedings may be made by:

(a) a debtor, in which case the debtor should show that it is or will be unable to pay its debts as and when they fall due [or that its liabilities exceed the value of its assets];
(b) one or more of its creditors that hold claims that are [mature and have not been paid by the debtor]][presently due and owing] [and the creditors can show that the business can continue to trade and can be successfully reorganized] or by one or more creditors that do not hold claims that are mature but who can show that the debtor [is or will be unable to pay its debts as and when they fall due [or that its liabilities exceed the value of its assets]];
[(c) a prescribed government or non-government authority on the basis of [...]].

(4) An application for commencement of proceedings should be made to the court. In the case of a voluntary application, the application should establish a prima facie case of insolvency and function as automatic commencement of proceedings. In the case of an involuntary application, the court should make a decision on that application as soon as possible and in any event within [...] days from the date of the application. The court may dismiss a proceedings [or convert it] if it is determined to be an abuse of the process.

(5) In the case of an application by one or more creditors or a governmental authority under paragraphs (1) and (2) above, notice of the application should be provided to the debtor and to other creditors at the time the application is made. Notification to the debtor should include: [...]. [*Notification to creditors: see (8).*]

(6) In the case of an application by a debtor, notice of the commencement of the proceedings should be provided to creditors.

(7) Notification of commencement of proceedings should be given to creditors individually, unless the court considers that, under the circumstances, some other form of notification would be more appropriate. [Notification should also be given to the known creditors that do not have addresses in this State. No letters rogatory or other, similar formality is required – *[Note to the Working Group: do the provisions of the Model Law need to be repeated here?]*

(8) The notification to creditors should:

(a) Indicate any applicable time period for making a claim and specify the place at which it can be made;
(b) Indicate whether secured creditors need to make a claim to the extent to which their claims are or are not covered by the value of the security; and
(c) Contain any other information required to be included in such a notification to creditors pursuant to [*the law of the State and the orders of the court*].

III. Consequences of commencement of insolvency proceedings

A. The insolvency estate

1. General remarks

40. Fundamental to the insolvency process is the need to identify, collect, preserve and dispose of assets belonging to the debtor. Many insolvency systems place the assets of the insolvent debtor under a special regime. This Guide uses the term "estate" in its functional sense to refer to assets of the debtor that are controlled by the insolvency representative and are subject to the insolvency proceedings. There are some important differences in the way in which the concept of the insolvency estate is understood in various jurisdictions. In some countries, the insolvency law provides that legal title over the assets is transferred to the designated official. In other countries, the debtor

continues to be the legal owner of the assets, but its powers to administer and dispose of the assets is limited (e.g. disposition, including by the creation of security rights, may require the consent of the insolvency representative).

41. Irrespective of the applicable legal tradition, an insolvency law will need to clearly define the assets that are subject to the insolvency proceedings (and therefore included within the concept of the "estate" where that term is used) and how they will be affected by those proceedings, as this will affect the scope and conduct of the proceedings and, particularly in reorganization, will have a significant bearing on the likely success of those proceedings. A clear statement will ensure transparency and certainty for both creditors and the debtor.

(a) Assets to be included in the estate

42. The estate may be expected to include the assets of the debtor as of the date of commencement of the insolvency proceedings as well as assets acquired by the insolvency representative and the debtor after that date, whether in the exercise of avoidance powers (see "Avoidance actions") or in the normal course of operating the debtor's business.

43. The estate may be expected to include all assets in which the debtor has an interest, whether or not they are in the possession of the debtor at the time of commencement, including all tangible and intangible assets. Tangible assets should be readily found on the debtor's balance sheets, such as cash, equipment, inventory, works in progress, bank accounts, accounts receivable and real estate. The assets to be included within the category of intangible assets may be defined differently in different States, depending upon the law, but may include intellectual property, contract rights, securities and financial instruments, and [...] [to the extent of the debtor's interest]. In the case of natural persons, the estate may also include assets such as inheritance rights in which the debtor has an interest or to which the debtor is entitled at the commencement of the insolvency or which come into existence during the insolvency proceedings.

44. Issues to be addressed:

[A/CN.9/504, para. 46: [...] It was further suggested that specific contractual arrangements, like transfers created for the purpose of security, trusts or fiduciary arrangements and consigned goods, needed to be addressed.]

(b) Assets that may be excluded from the estate

(i) Where the insolvent is a natural persons

45. In the case of a the insolvency of a natural person the estate may exclude certain assets such as those relating to post-application earnings from the provision of personal services, assets that are necessary for the debtor to earn a living and personal and household assets. Where the insolvency law provides exclusions in respect of the assets of a natural person, those exclusions should be clearly identified and their number limited to the minimum necessary to preserve the personal rights of the debtor and allow the debtor to lead a productive life.

(ii) Secured assets

46. Insolvency laws adopt different approaches to the treatment of assets subject to security interests. Many laws provide that secured assets are included in the debtor's estate, with the commencement of proceedings giving rise to different effects. Some insolvency laws restrict the exercise of security rights held by creditors or third parties (such as by application of a stay and other effects of commencements), while others provide that the security right is unaffected by the insolvency and creditors may proceed to enforce their legal and contractual rights (see "Stay of proceedings"). Some insolvency laws which require all assets to be subject to the proceedings in the first instance allow them to be separated where there is proof of harm or prejudice. Where secured assets are to be included within the estate, the insolvency law should make it clear that secured creditors will not be deprived of their rights by such an inclusion.

47. Exclusion of secured assets may have the advantage of enhancing the availability of credit because secured creditors would be reassured that their interests would not be adversely affected by the commencement of insolvency proceedings. This advantage, however, may need to be weighed against the advantages to be derived, particularly in the case of reorganization and also where the business is to be sold as a going concern in liquidation, from having all assets of the debtor available to the insolvency proceedings from the time of commencement. This approach may assist not only in ensuring equal treatment of creditors, but may be essential to the reorganization proceedings where the secured asset is central to the business; where manufacturing equipment, for example, is central to the debtor's business operations, reorganization cannot take place unless it can be retained for the proceedings. Where issues arise as to whether particular assets are essential to the business, that determination could be made by the insolvency representative or perhaps the creditor committee.

(iii) Third party owned assets

48. Complex issues may be raised in determining whether an asset is owned by the debtor or by another party and whether assets of a third party that are in the possession of the debtor, subject to use, lease or licensing arrangements, at the time of commencement should be included within the assets of the estate. In some insolvency cases those assets may be crucial to the continued operation of the business, particularly in reorganization proceedings but also to a lesser extent in some liquidation proceedings, and it will be advantageous for the insolvency law to provide some mechanism which will enable those assets to remain at the disposal of the insolvency proceedings. Some insolvency laws address this issue in terms of the types of assets to be included within the scope of the insolvency estate. Other insolvency laws, where the possession of the asset by the debtor is subject to a contractual arrangement, address it in the context of the treatment of contracts. This may include, for example, imposing restrictions on the termination of the contract pursuant to which the debtor holds the assets, preventing the owner from reclaiming its assets in the insolvency (see "Treatment of contacts").

49. Those assets being used by the debtor, but which are subject to a lease agreement where the lessor retains legal title may require special attention. In countries where title financing (where the provider of finance has title or ownership of the asset as opposed to a mortgage or security interest) is of considerable importance, there may be a need to respect the creditor's legal title in the asset and allow it to be separated from the estate (subject to the rules on treatment of contracts: the right to separate may be limited if the insolvency

representative ratifies the lease contract). By way of comparison, there are also examples of laws which provide for a court-ordered moratorium that prevents third parties from claiming their assets for a limited period of time after commencement. A balance between these two approaches may be desirable, with a view to achieving maximization of value and ensuring that the sale of the business as a going concern or a reorganization may not be rendered impossible by the free separation of the relevant asset. There may also be circumstances where these type of financing arrangements should be scrutinized in order to determine whether the lease is, in fact, a disguised secured lending arrangement. In that case the lessor would be subject to the same restrictions as the secured lender.

(c) Recovery of assets

50. Identifying the assets that will be subject to the proceedings may require action by the insolvency representative to recover assets of the estate that were improperly transferred or transferred at a time of insolvency with the result that the *pari passu* principle (i.e. that creditors of the same class are treated equally and are paid in proportion to their claim out of the assets of the estate) has been violated. Most legal systems provide a means of setting aside and recovering the value of antecedent transactions that result in preferential treatment to some creditors or were fraudulent in nature or made in an effort to defeat the rights of creditors (see "Avoidance actions"). The power to recover assets or their value may also extend to transfers made by the debtor after commencement of the proceedings where the transfer was not authorized by the insolvency representative.

(d) Disposal of assets

51. Where assets have a negative or insignificant value, or are not essential to a reorganization, it may be consistent with the objective of maximizing value to allow the insolvency representative to abandon them, provided such abandonment does not violate any compelling public interest. Abandoning assets in this way will assist to reduce the costs of the proceedings to the estate.

52. Issues to be addressed: *methods for sale of assets and ability to sell free and clear of security interest, charges and other encumbrances.*

2. Summary and recommendations-insolvency estate

(1) The purpose of provisions in an insolvency law relating to the insolvency estate is to identify those assets that will be subject to the control of the insolvency representative and subject to the insolvency proceedings.

(2) On commencement of insolvency proceedings, the insolvency estate should include:

(a) assets in which the debtor has in interest as at the date of commencement of the insolvency proceedings. This would include both tangible and intangible assets, irrespective of whether it is in the possession of the debtor or subject to a security interest in favour of a creditor;

(b) assets acquired after commencement of the insolvency proceedings, whether acquired in the exercise of avoidance powers or in the normal course of business.

(3) Where the debtor is a natural person, the insolvency law may specify assets required to preserve the personal rights of the debtor that should be excluded from the insolvency estate.

(4) The insolvency law should provide a mechanism for retaining in the estate assets owned by a third party that are in the possession of the debtor at the date of commencement and secured assets where those assets are essential to the insolvency proceedings. The insolvency law should make provision for protection of the owner of the assets in situations where there is proof of harm of prejudice. [Assets owned by a third party in the possession of the debtor but subject to a contractual arrangement may be included subject to other provisions of the insolvency law such as those dealing with continuation and termination of contracts, and application of the stay.]

B. Protecting the insolvency estate

1. General remarks

53. An essential objective of an effective insolvency system is the establishment of a protective mechanism to ensure that the value of the estate's assets is not diminished by the actions of the various parties in interest. The parties from whom the estate needs the greatest protection are the debtor and its creditors. The manner in which the estate can be protected from the actions of the debtor are considered under "Debtor's rights and obligations".

(a) Protection of the estate against creditors and third parties

54. With regard to creditors, one of the fundamental principles of insolvency law is that it is a collective proceeding, which requires that the interests of all creditors be protected against individual action by one of them. Many insolvency systems provide for the imposition of a mechanism that prevents creditors from enforcing their rights through legal remedies during some or all of the period of the liquidation or reorganization proceedings, recognizing the collective nature of the proceedings and operating to enhance the collective interests of the creditors. This mechanism is variously termed a moratorium, suspension or stay, depending on the scope of the mechanism. For the purposes of this Guide, the term "stay" is used in a broad sense to refer to both suspension of actions and a moratorium against the commencement of actions.

55. As a general principle, the imposition of a stay in liquidation can ensure a fair and orderly administration of the insolvency proceedings, providing the insolvency representative with adequate time to avoid making a forced sale that fails to maximize the value of the assets being liquidated, and also an opportunity to see if the business can be sold as a going concern. In reorganization proceedings, a stay of proceedings allows the debtor a breathing space to organize its affairs and time for preparation of a reorganization plan and to take the other steps necessary to ensure success of the reorganization, such as shedding unprofitable activities and onerous contracts. As such, the impact of the stay is greater and therefore more crucial in reorganization than in liquidation and can provide an important incentive to encourage debtors to initiate reorganization proceedings. At the same time, the commencement of proceedings and the imposition of the stay put on notice all those who do business with the debtor, that the future of the business is uncertain. This can cause a crisis of confidence and

uncertainty as to how the insolvency will impact upon them as suppliers, customers and employees of the business.

56. One of the key issues in the design of an effective insolvency law is how to balance the immediate benefits that accrue to the entity by having a broad stay quickly imposed to limit the actions of creditors and the longer-term benefits that are derived from limiting the degree to which the stay interferes with contractual relations with creditors.

57. The scope of rights that are affected by the stay varies considerably among countries. There is little debate regarding the need for the suspension of actions by unsecured creditors against the debtor or its assets. The application of the stay to secured creditors, however, is potentially more difficult and requires a number of competing interests to be balanced. These include, for example, observing commercial bargains and contracts; respecting priorities of secured creditors as regards their rights over the security; protecting the value of secured interests; ensuring that creditors are paid out of the assets of the estate in proportion to their claim; maximizing asset values for all creditors; and, in cases of reorganization, ensuring the successful reorganization of a viable entity.

(b) Provisional measures

58. Between the time when the debtor or creditor makes an application for commencement of insolvency proceedings and the time when the proceedings actually commence, there is the potential for dissipation of the debtor's assets. Upon the making of the application, the debtor may be tempted to transfer assets out of the business and creditors, on learning of the application, may take remedial action against the debtor to preempt the effect of any stay that may be imposed upon commencement.

59. Some insolvency laws allow the court to order protective measures to protect the estate in the period between application and commencement of proceedings, either on the application of creditors or on its own motion. Where these provisional measures are available they may include: appointing a preliminary insolvency representative; prohibiting the debtor from disposing of assets; sequestering some or all of the debtor's assets; suspending enforcement of security interests against the debtor; staying any action to separate a debtor's assets, such as by a secured creditor or holder of a retained title; or preventing the commencement of individual actions by creditors to enforce their claims. Since these measures are provisional in nature and are provided before the decision that the commencement criteria have been met, applying creditors may be required by the court to provide evidence that the measure is necessary and, in some cases, some form of security for costs or damages that may be incurred.

(c) Application of a stay–procedural issues

(i) Scope of the stay

60. Some countries adopt the approach that to ensure the effectiveness of the stay, it must be very wide, applying to all remedies and proceedings against the debtor and its assets, whether administrative, judicial or self-help and restraining both unsecured and secured creditors from exercising enforcement rights, as well as governments from exercising priority rights *[To be expanded: extent to which government entities immune from court action or distinction made between State action to enforce police or regulatory powers and to enforce pecuniary interests*]. Examples of the types of actions that may be stayed could include: the commencement or continuance of actions or proceedings against

the debtor or in relation to its assets; the commencement or continuance of enforcement proceedings in relation to assets of the debtor, including the execution of a judgement and a security enforcement process; recovery by any owner or lessor of property that is used or occupied by or is in the possession of the debtor; payment or provision of security in respect of a debt incurred by the debtor prior to the commencement date; the right to transfer, encumber or otherwise dispose of any assets of the debtor; and termination, suspension or interruption of supplies of essential services (for example, water, gas, electricity and telephone) to the debtor. Article 20 of the UNCITRAL Model Law on Cross-Border Insolvency, for example, provides that commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities and execution against the debtor's assets is stayed.

61. In liquidation, where legal proceedings against the debtor are often included within the scope of the stay, provision is made in some insolvency laws for those proceedings to be continued if necessary. Article 20(3) of the UNCITRAL Model Law on Cross-Border Insolvency, for example, provides that the application of the stay to commencement or continuation of individual actions or proceedings against the debtor is not to affect the right to commence individual actions or proceedings to the extent necessary to preserve a claim against the debtor. In contrast, some insolvency laws exclude legal proceedings from the scope of the stay in reorganization. In some countries, employee actions against the debtor are not included within the stay, but any enforcement action resulting from those proceedings will be included.

62. The inclusion or exclusion of actions from the scope of the stay should be stated clearly in the insolvency law, irrespective of who may commence those actions, whether creditors (including preferential creditors such as employees, legislative lienholders or governments) or third parties (such as a lessor or owner of property in the possession or use of the debtor or occupied by the debtor).

63. The need for other exemptions, such as for set-off rights and netting of financial contracts (see "Treatment of contracts"), or exemptions to protect public policy interests or to prevent abuse, such as the use of insolvency proceedings as a shield for illegal activities, may also need to be considered.

(ii) Discretionary or automatic application of the stay

64. A preliminary question is whether the stay applies automatically or at the discretion of the court. Local policy concerns and factors such as the availability of reliable financial information and the ability of the debtor and creditors to have access to an independent judiciary with insolvency experience may affect the decision as to whether the stay is applied automatically or granted by the courts on a discretionary basis. Applying the stay on a discretionary basis may allow the stay to be tailored to the needs of the specific case (as regards the debtor, its assets and its creditors) and avoid both unnecessary applications of the stay and unnecessary interference with the rights of secured creditors. However, to avoid delay and the need for an application to the court, to assist the achievement of the maximization of the value of the assets and to ensure that the insolvency process is fair and ordered as well as transparent and predictable, it may be argued that the stay should apply automatically; the automatic stay is a feature of many modern insolvency law regimes.

(iii) Time of application of the stay

65. A concern related to how the stay should be applied is the time at which the stay will apply in both liquidation and reorganization proceedings and whether the insolvency law should draw any distinction, for that purpose, between applications made by a debtor and applications made by a creditor.

66. Different approaches may be taken to address these issues. One approach may be for the stay to apply on the making of an application for both liquidation and reorganization proceedings, irrespective of whether it is a debtor or creditor application, thus avoiding the need to consider the availability of interim or provisional measures of protection to cover the period between application and commencement. Once the proceedings commence, the stay would continue to apply in the case of reorganization. In the case of liquidation, continued application of the stay could be discretionary where the assets were to be sold in a piecemeal manner. Where the business was to be sold as a going concern, however, it may be advantageous to the administration of the proceedings for the stay to continue to apply after commencement.

67. A second approach may distinguish between debtor and creditor applications. This approach would provide for the stay to apply on a creditor application for both liquidation and reorganization proceedings, after commencement of the proceedings, with protective or interim measures being available from the court to cover the period between application and commencement. Where the debtor applies for insolvency proceedings (whether liquidation or reorganization), the stay could apply automatically on application to avoid the possibility of creditors taking action, particularly enforcement actions, against the debtor in the period before commencement.

(d) Application of the stay to unsecured creditors

68. Many insolvency laws provide that the stay applies to unsecured creditors in both liquidation and reorganization proceedings for the duration of the proceedings.

(e) Application of the stay to secured creditors

69. Creditors generally seek security for the purpose of protecting their interests in the event that the debtor fails to repay. If security is to achieve this objective, it can be argued that, upon commencement of insolvency proceedings, the secured creditor should not be delayed or prevented from immediately realising its security. The secured creditor has, after all, bargained for security in exchange for value that reflects the reliance on the security. For that reason, the introduction of any measure that will diminish certainty in the ability to recover debt or erode the value of security interests, such as applying the stay to secured creditors, may need to be carefully considered. Such a measure may ultimately undermine not only party autonomy and the importance of observing commercial bargains, but also the availability of affordable credit: as the protection provided by security interests declines, the price of credit may need to increase to offset the greater risk.

70. Nevertheless, some insolvency laws recognize that in some cases permitting secured creditors to freely separate their security from the other assets that are subject to the insolvency proceedings can frustrate the basic objectives of those proceedings. In reorganization proceedings, where assets essential to the operation of the debtor's business are encumbered by security interests, enforcement by secured creditors of their

claims at the commencement of the proceedings may make it impossible for the debtor to keep the business operating while it formulates a reorganization plan. This is also true, although to a lesser extent, in liquidation proceedings. As a general principle, where the insolvency representative's function is to collect and realize assets and distribute proceeds among creditors by way of dividend, the secured creditor may be permitted to freely realize its security despite the liquidation. However, there will be cases where the insolvency representative may be able to achieve a better result that maximizes the value of the assets for the collective benefit of all creditors if the stay is applied to restrict free separation of the security. This is particularly relevant where there is the possibility of selling the business as a going concern. It may also be true in some cases where even though assets are to be sold in a piecemeal manner, some time is needed to arrange a sale that will give the highest return for the benefit of all unsecured creditors.

71. Where secured interests are included within the scope of the stay, the insolvency law can adopt measures that will ensure the secured rights are not negated by the stay. These measures may relate to the duration of the stay, protection of the value of the security, payment of interest and by providing that the stay can be lifted where the secured interests are not sufficiently protected or where the security is not necessary to the sale of the entire business or a productive part of it.

(i) Liquidation

72. Insolvency laws take different approaches to the application of the stay to secured creditors in liquidation proceedings. Some insolvency laws exclude secured creditors from the scope of the stay on the basis that where the assets are to be liquidated the balance should weigh in favour of upholding the rights of secured creditors to enforce their rights. Where that approach is adopted, some flexibility may be needed, however, to address the situation where the business can be sold as a going concern within the context of the liquidation proceeding. Some of the insolvency laws that exclude secured creditors from the stay focus on encouraging pre-commencement negotiations between the debtor and creditors to achieve agreement on how to proceed. Where that process is effective, a stay applying to secured creditors may not be required. Other laws adopt the approach that the stay automatically applies upon commencement of liquidation proceedings to secured creditors but only for a brief period, such as 30 or 60 days, except in those cases where the security is essential to the sale of the business as a going concern (in which case the stay may be extended). This period would allow the insolvency representative to assume its duties and take stock of the assets and liabilities of the estate. Another approach extends the stay to secured creditors for the duration of the liquidation proceedings, subject to a court order for relief where it can be shown that the value of the security is being adversely affected.

73. Where the stay is limited to a specified period, the law may include provision for extension of the stay. This could be on application by the insolvency representative when it can be demonstrated that an extension is required in order to maximize value (there is a reasonable possibility that the entity, or units of the entity, can be sold as a going concern) provided that secured creditors will not suffer unreasonable harm. To provide additional protection and avoid the stay being applied for an uncertain or unnecessarily lengthy period, an insolvency law may limit the period for which the stay can be extended.

(ii) Reorganization

74. In proceedings where there is a genuine possibility of effecting a reorganization, it is desirable that the extent of the stay should be very wide and all embracing. In some cases it may also be desirable for the stay to apply to secured creditors for the duration of the proceedings to ensure that the reorganization can proceed in an orderly manner without the possibility of assets being separated before the reorganization can be finalised. However, to avoid delay and encourage a speedy resolution of the proceedings, there may also be some advantage in limiting the application of the stay to the time that it may reasonably take for a reorganization plan to be approved; it is not desirable that the stay apply for an uncertain or unnecessarily lengthy period. Such a limitation would also have the advantage of providing secured creditors with a degree of certainty and predictability as to the duration of the period of interference with their rights. Where the particular security is not essential to the reorganization or where the creditor can demonstrate other reasons, provision may be made in the insolvency law for the stay to be lifted (see below).

(f) Protection of secured creditors

(i) Maintaining the economic value of secured claims

75. Although some minor erosion of secured creditors' security positions is to be expected in conjunction with a reorganization proceeding, it is undesirable that a single secured creditor or group of secured creditors solely or primarily bear the burden.

76. One of the set of measures designed to address the negative impact of the stay on secured creditors in liquidation is that directed at maintaining the economic value of secured claims during the period of the stay (in some jurisdictions referred to as "adequate protection"). One approach is to protect the value of the security itself on the understanding that, upon liquidation, the proceeds of sale of the security will be distributed directly to the creditor to the extent of the value of the secured portion of their claim. This approach may require a number of steps to be taken.

77. During the period of the stay it is possible that the value of the creditor's security will depreciate. This potentially will affect the priority afforded to the creditor at the time of distribution, since the priority will be limited by the value of the security. Some insolvency laws provide that the insolvency representative should compensate secured creditors for the amount of this depreciation by providing substitute security or making periodic cash payments corresponding to the amount of the depreciation. Some countries that preserve the value of the security as outlined also allow for payment of interest during the period of the stay, but only to the extent that the value of the security exceeds the value of the secured claim. Such an approach may encourage lenders to seek adequate security that will exceed the value of their claims. In some cases the insolvency representative may find it necessary to use or sell encumbered assets prior to liquidation in order to maximize the value of the estate. For example, to the extent that the insolvency representative is of the view that the value of the estate can best be maximized if the business continues to operate for a temporary period, it may wish to sell inventory that is partially encumbered. Thus, in cases where secured creditors are protected by preserving the value of the security, it may be desirable for the insolvency law to allow the insolvency representative the choice of providing the creditor with substitute equivalent security or paying out the full amount of the secured claim.

78. Another approach to protecting the interests of secured creditors will be to protect the value of the secured portion of the claim. Immediately upon commencement, the encumbered asset is valued and, based on that valuation, the value of the secured portion of the creditor's claim is determined. This value remains fixed throughout the proceedings and, upon distribution following liquidation, the secured creditor receives a first-priority claim to the extent of that value. During the proceedings, the secured creditor could also receive the contractual rate of interest on the secured portion of the claim to compensate for delay imposed by the proceedings. Provision of interest is limited in some insolvency laws to situations where the value of the security exceeds the amount claimed. Otherwise, compensation for delay may deplete the assets available to unsecured creditors.

79. The desirability of the types of approaches that provide protection for the security may need to be weighed against the potential complexity and cost of those measures and the need for the court to be able to make difficult commercial decisions on the question of appropriate protection. Where such an approach is adopted, it may be desirable for an insolvency law to provide guidance to determine when and how creditors holding some type of security over the debtor's assets would be entitled to the types of protection described above.

(ii) Surrender of the security

80. In liquidation [and reorganization], provision may be needed to allow secured assets to be surrendered to the secured creditor, where its security is determined to be valid and the secured assets have no value to the insolvent estate, or cannot be realized in a reasonable period of time by the insolvency representative.

(iii) Lifting the stay

81. In liquidation and reorganization proceedings, circumstances may arise where it is appropriate to provide relief from the application of the stay by allowing the stay to be lifted or cease to apply. Those circumstances may include where the secured creditor is not receiving protection for the value of its security, where the provision of protection may not be feasible or would be overly burdensome to the estate or where the security is not needed for the reorganization. To accommodate such circumstances, an insolvency law may provide that the secured creditor can apply for the stay to be removed or the insolvency representative can be given the power to release the security without needing approval of the court.

82. While provisions on the lifting of the stay principally address the interests of secured creditors, there are examples of insolvency laws which provide that relief from the stay may be granted to an unsecured creditor to allow, for example, a claim to be determined in another forum where litigation may be well advanced and it would be efficient for it to be completed, or a claim against an insurer of the debtor to be pursued.

(g) Limitations on disposal of assets by the debtor

83. In addition to measures designed to protect the insolvency estate against the actions of creditors and third parties, insolvency laws generally adopt measures which are intended to limit the extent to which the debtor and the insolvency representative can deal with the assets of the estate. These issues are addressed in the following

sections on treatment of contracts, debtor's rights and obligations and insolvency representative's rights and obligations.

2. Summary and recommendations—protecting the insolvency estate

(1) The purpose of these provisions is to:

(a) provide a mechanism, such as a stay, that will ensure that the value of the estate is not diminished by the actions of the various parties in interest;
(b) determine the scope of the activities to be affected by the stay;
(c) identify the parties to whom the stay will apply and the conditions of its application, including method, time and duration of application ;
(d) [...].

Variant 1 - Discretionary application of the stay

(2) In both liquidation and reorganization proceedings, the court may, upon the application of an interested party, safeguard the interests of creditors and other persons by making appropriate orders specifying the actions against the debtor that are to be stayed. The stay could be applied at the discretion of the court to both unsecured and secured creditors, or a discretionary stay of secured creditors could be combined with an automatic application to unsecured creditors.

(3) Where application of the stay is discretionary, the insolvency law may need to include measures to encourage the use of pre-commencement negotiation to achieve the best result for all creditors.

Variant 2 - Automatic application of the stay

Liquidation

(2) A stay would [automatically] come into effect against secured and unsecured creditors:

(a) Where the application is made by the debtor, on [the making of the application] [commencement of the proceedings];
(b) Where the application is made by one or more creditors, on [the making of the application] [commencement of the proceedings].

(3) Where the stay applies on commencement of proceedings, the court may, on the application of an interested party, safeguard the interests of creditors and other persons by making appropriate provisional orders. Those orders may include: [...].

(4) A stay applicable to unsecured creditors should apply for the duration of the liquidation proceedings.

(5) Where the stay comes into effect upon the making of the application, the court may order, on commencement of proceedings, the continued application of the stay to secured creditors for [between 30-60 days]. After that time the insolvency representative may apply for the stay to be extended for a further

period of [...days] provided it can show that the extension is necessary to maximize the value of the assets for the benefit of all creditors and that secured creditors will suffer no unreasonable harm.

(6) A secured creditor may apply to the court for relief from the application of the stay where it can demonstrate severe prejudice (eg. it is not receiving appropriate protection of the economic value of the security). An insolvency representative may release the security where it determines that the protection of the value of the security is not be feasible or will be overly burdensome to the insolvency proceedings; where the secured assets has no value to the estate or cannot be realized in a reasonable period of time; and where the security is not essential to the sale of the business as a whole.

Reorganization

(7) The considerations as to the time at which the stay is effective are the same for reorganization as for liquidation.

(8) Where the stay comes into effect upon the making of the application it would continue automatically after commencement of proceedings and not be subject to the discretion of the court, except as to lifting of the stay with respect to individual creditors.

(9) The stay should apply equally to both secured and unsecured creditors, subject to provision for relief and [for the duration of the proceedings] [for the time that it may reasonably take for the reorganization plan to be approved.

(10) A secured creditor may apply to have the stay lifted where it can demonstrate severe prejudice (eg. it is not receiving appropriate protection of the economic value of the security). The stay may cease to apply where the insolvency representative determines that protection of the value of the security is not feasible or will be overly burdensome; that the secured assets has no value to the estate or cannot be realized in a reasonable period of time or that the security is not required for the reorganization proceedings.

(11) Where the stay applies to secured creditors, the insolvency law should adopt specific measures addressing protection of the security.

C. Treatment of contracts

1. General remarks

84. It is almost inevitable that at the commencement of insolvency proceedings, the debtor will be a party to at least one contract that has not yet been fully performed by either party or by both parties.

85. No special rules are required for the situation where one party has fully performed its obligations. If it is the debtor that has not or not fully performed, the other party's claim for performance or damages will be an insolvency claim that should be made in the proceedings. If it is the counterparty that has not or not fully performed its obligations, the insolvency representative can demand performance or damages from

that party. Where both parties have not or not fully performed their obligations, it is a common feature of many insolvency laws that the insolvency representative may interfere in those contracts, electing to either reject and terminate or continue (and possibly subsequently assign) those contracts. Pending continuation or termination of a contract, it is desirable that the insolvency representative [the estate] be required to pay for any benefits received under the contract.

86. As an economy develops, more and more of its wealth is apt to be contained in or controlled by contracts, rather than contained in land. As a result, the treatment of contracts in insolvency is of overriding importance. There are two overall difficulties in developing legal policies in that regard. The first difficulty is that contracts are unlike all other assets of the insolvent estate in that usually they are tied to liabilities or claims. That is, it is often the case that the estate must perform or pay in order to enjoy the rights that are potentially valuable assets. The result is that difficult decisions must be made about the treatment of a contract so as to produce the most value for the estate. Typically, the insolvency representative is charged with making this evaluation. In some jurisdictions, court approval is also required.

87. Achieving the objectives of maximizing the value of the estate and reducing liabilities and, in reorganization, enabling the entity to survive and continue its affairs to the maximum extent possible in an uninterrupted manner may involve taking advantage of those contracts that are beneficial and contribute value and rejecting those which are burdensome, or those where the ongoing cost exceeds the benefit of the contract. As an example, in a contract where the debtor had agreed to purchase a particular good at a price which is half the market price at the time of the insolvency, obviously it would be advantageous to the insolvency representative to continue to purchase at the lower price and sell at the market price. The counterparty would naturally like to get out of what is now an unprofitable agreement, but in many systems it will not be permitted to do so, although it may be entitled to an assurance that it will be paid the contract price in full.

88. There are, however, a number of competing interests against which achievement of these objectives may need to be balanced. These include the social concerns raised by some types of contracts such as employment contracts (see ...), and the effect of the insolvency representative's ability to interfere with the terms of unperformed contracts on the predictability of commercial and financial relations and on the cost and availability of credit (the wider the power of the insolvency representative to interfere in contracts, the higher the cost and the lower the availability of credit is likely to be). The insolvency representative's ability to terminate employment contracts, for example, may be limited by concerns that liquidation can be used as a means of expressly eliminating the protections afforded to employees by such contracts. Other types of contracts requiring special treatment include financial market transactions (see ...) and contracts for personal services, where the identity of the party to perform the agreement, whether the debtor or an employee of the debtor, is of particular importance. A related issue is the circumstances in which an insolvency representative may alter the terms and conditions of contracts of the type requiring special treatment.

89. The second difficulty is that contracts are of many different types. They include simple contracts for the sale of goods; short-term or long-term leases of land or of personal property; and immensely complicated contracts for franchises or for the construction and operation of major facilities, among many others. Additionally, the debtor could be involved in the contract as buyer or seller, lessor or lessee, licensor or licensee, provider or receiver and the problems presented in insolvency may be very

different when viewed from different sides. A common solution is to provide general rules for all kinds of contracts and exceptions for certain special contracts, as discussed below.

90. Contracts in bankruptcy fall into two categories: contracts made before insolvency by the debtor and contracts entered into after the start of an insolvency proceeding. In many laws breach of a contract in the first category (pre-insolvency contracts) gives rise to an unsecured claim that is usually paid on a pro-rata basis. Breach of a contract in the second category (post-insolvency contract) is usually a first claim on the available funds and therefore is paid in full as an expense of the insolvency administration (see "Distribution priorities"). The line between these two types of contract is crossed when the insolvency representative seeks to perform a pre-insolvency contract based on an evaluation that performance of the contract will yield greater net returns than its breach. If the contract is thus continued, it is effectively adopted and in many insolvency laws any later breach will also be a first-priority administration claim.

91. Whatever rules are adopted with respect to continuation and termination, it is desirable that any right to continue or terminate a contract should be limited to the contract as a whole, thus avoiding a situation where the insolvency representative could choose to continue certain parts of a contract and terminate others.

(a) Continuation

92. Different approaches to the continuation of contracts are evident in different insolvency laws. Some insolvency laws require the insolvency representative to make a decision as to continuation and set a deadline by which this must be done; failure to act within the specified time results in the contract being deemed to have been rejected. Under other laws, contracts are unaffected by the commencement of insolvency proceedings so that contractual obligations remain binding and the general rules of contract law will continue to apply unless the insolvency law expressly provides for different rules to be applied, as in the case of termination and overriding automatic termination clauses (see below).

93. Continued contracts are treated as ongoing obligations of the insolvent entity that must be performed and all contractual obligations of the estate become post-commencement obligations. Where the debtor is in default under a contract at the time of the application for insolvency, the policy issue is whether it is fair to require the counterparty to continue to deal with an insolvent debtor when there was already a pre-insolvency default. Some insolvency laws require, as a condition of continuation, that the insolvency representative cure any defaults under the contract and provide assurance as to future performance by providing, for example, a bond or guarantee.

94. Claims arising from the performance of the contract after the commencement of insolvency proceedings are treated in a number of insolvency laws as an administrative expense (see ...) and given priority in distribution. Since the granting of such a priority constitutes a potential risk for other creditors (who will be paid after the priority creditors), it is desirable that only contracts that will be profitable and contracts that are essential to the continued operation of the debtor be continued. Where the insolvency representative breaches an agreement after it has been continued, the party who has been damaged as a result of the breach may be entitled to pursue its rights and remedies under the agreement in accordance with applicable non-insolvency law and to the

payment of damages, which may also rank as an administrative claim (as opposed to an unsecured claim).

(i) Reorganization

95. In reorganization, where the objective is to enable the entity to survive and continue its affairs to the extent possible, the continuation of contracts that are beneficial to the business and contribute value may be crucial.

96. Many contracts include a clause providing that commencement of insolvency proceedings constitutes an event of default that gives the counterparty an unconditional right of termination or acceleration, or some other right. Some laws uphold the validity of these clauses and where the insolvency representative seeks to continue the contract, it will only be able to do so if the counterparty does not elect, or can be persuaded not to elect, to terminate or accelerate the contract. Where a counterparty can terminate a contract, an insolvency law may provide a mechanism that can be used to persuade the counterparty to continue the contract, such as establishing a priority for payment for services provided after commencement of the proceedings (in some insolvency laws this may exist as a general provision which typically treats costs incurred after the commencement of proceedings as a first priority from unencumbered assets).

97. The approach of upholding termination clauses may be supported by a number of factors including: the desirability of respecting commercial bargains; the need to prevent the debtor from selectively performing contracts which are profitable and cancelling others (an advantage which is not available to the innocent counterparty); the effect of such an override provision on netting; the belief that since an insolvent business will generally be unable to pay, delaying the termination of contracts potentially only increases existing levels of debt; the need for creators of intellectual property to be able to control the use of that property; the effect on the counterparty's business of termination of a contract with respect to a general intangible; and the undesirability of compelling a transfer of a contract to a transferee who may not be known to the counterparty or with whom the counterparty may not wish to do business.

98. A second approach provides that the insolvency representative can continue the contract over the objection of the counterparty, that is, any event of default which is triggered by commencement of insolvency proceedings which would give rise to a right to terminate or accelerate the contract is overridden by operation of the law. Permitting these termination and acceleration clauses to be overridden in reorganization proceedings may be crucial to the success of the proceedings where, for example, the contract is a critical lease or involves the use of intellectual property embedded in a product. It may also enhance the earnings potential of the business; reduce the bargaining power of an essential supplier; and capture the value of the debtor's contracts for the benefit of creditors. Where an insolvency law provides that termination clauses can be overridden, creditors may be tempted to take pre-emptive action to avoid that outcome by terminating the contract before the application for insolvency proceedings is made (assuming default of the debtor other than one triggered by commencement of the proceedings). Such a result may be mitigated by providing that the insolvency representative has the power to reinstate those contracts, provided that both pre- and post-commencement obligations are fulfilled.

99. Although some jurisdictions have implemented provisions allowing termination clauses to be overridden, it has not yet become a general feature of insolvency laws.

There is an inherent tension between promoting the debtor's survival, which requires the preservation of contracts, and injecting unpredictability and extra cost into commercial dealings by creating a variety of exceptions to the general rules. While this issue is one which may require a careful weighing of the advantages and disadvantages there are, nevertheless, circumstances where the ability of the insolvency representative to continue contracts will be crucial to the conduct and successful implementation of reorganization and also, but perhaps to a lesser extent, liquidation where the business is to be sold as a going concern. Any negative impact of a policy of overriding termination clauses can be balanced by providing compensation to creditors who can demonstrate that they have suffered damage or loss as a result of the continuation of the contract.

(ii) Liquidation

100. In liquidation, the desirability of continuing contracts is likely to be less important than in reorganization, except where the contract may add value to the business or to a particular asset or promote the sale of the business as a going concern. A lease agreement, for example, where the rental is below market value and the remaining term is substantial, may prove central to any proposed sale of the business or may be sold to produce value for creditors.

101. The arguments in favour of overriding termination clauses in liquidation would include the need to keep the business together to maximize its sale value or to enhance its earnings potential; to capture the value of the contract for creditors rather than forfeiting it to the counterparty; and the desirability of locking all parties into the final disposition of the business. *[other justifications?]*

(iii) Exceptions

102. Exceptions to the power of the insolvency representative to continue contracts generally fall into two categories. In respect of the first, where the insolvency representative has the power to override termination provisions, specific exceptions may be made for contracts such as short-term financial contracts (e.g. swap and futures agreements). The second category relates to those contracts where, irrespective of how the insolvency law treats termination provisions, the contract cannot be continued because it provides for performance by the debtor of irreplaceable personal services (e.g. an opera singer).

(b) Termination

(i) Liquidation

103. For the general reasons discussed in the introduction above, it is desirable that an insolvency representative has the power to terminate a contract in which both parties have not fully performed their obligations.

104. Different mechanisms may be adopted to terminate a contract. Under one approach the insolvency representative is required to take action to terminate the contract, such as by providing notice to the counterparty that the contract is to be terminated. This approach may not achieve the key objectives of certainty, predictability and efficient progress of the proceedings if the insolvency representative does not take timely action to terminate and allows the matter to continue unresolved for some time. It may also lead to the accrual of

unnecessary expense (e.g. rent for real or personal property which is leased by the debtor can be a significant administrative cost if a lease is not promptly terminated).

105. Under a second approach the contract may be regarded as automatically terminated if the insolvency representative does not elect to continue it within a specified time period, which may be longer in reorganization than in liquidation. This approach is aimed at ensuring certainty for both parties. It requires the insolvency representative to take timely action with respect to contracts outstanding at the time of commencement and offers the counterparty some certainty as to the continued existence of the contract within a reasonable period after commencement. *[other justifications?]*

106. Where a contract is terminated, the counterparty is excused from performing the rest of the contract and the only serious issue to be determined is calculation of the unsecured damages that result from the termination. The counterparty becomes an unsecured creditor with a claim equal to that amount of damages. Where a contract has been performed for a period of time during the insolvency proceedings before being terminated, the counterparty may have claims both for the period before termination (which may rank as an administrative claim) and for the damages resulting from the termination.

(ii) Reorganization

107. In reorganization, the prospects of success may be enhanced by allowing the insolvency representative to reject burdensome contracts. These may include contracts where the cost of performance is higher than the benefits to be received or, in the case, for example, of an unexpired lease, the contract rate exceeds the market rate.

108. However, while in liquidation it may be reasonable to assume that the failure of the insolvency representative to take a decision with respect to a contract would most likely imply a decision to terminate, the same assumption may not always be appropriate in reorganization. In reorganization, it may be appropriate to allow the insolvency representative to make a decision as to termination up to the time of approval of the reorganization plan, provided that any benefit received under the contract is paid for and that the counterparty has the ability to compel an earlier decision where it is required or desired. It is desirable that treatment of specific contracts be addressed clearly in the plan, with perhaps a provision that contracts not so addressed should be treated as automatically rejected on approval of the plan.

(iii) Exceptions

109. Irrespective of the extent of the termination powers given to an insolvency representative, exceptions may be needed for certain contracts. One important exception to the power to terminate is employment contracts (see (d) below). A similar limitation may appropriately be applied to the case of agreements where the debtor is a lessor or franchisor, or a licensor of intellectual property and termination of the agreement would end or seriously affect the business of the counterparty, particularly where the advantage to the debtor may be relatively minor. Where the debtor is a lessee, it may be desirable to set a ceiling on damages (which may be a monetary amount or a specified period of time in respect of which damages may be payable) so that the claim under a long-term lease does not overwhelm the claims of other creditors. Lessors ordinarily can mitigate losses by re-letting the property.

(c) Assignment

110. The ability of the insolvency representative to elect to continue and assign contracts notwithstanding insolvency triggered termination provisions or restrictions on transfer contained in the contract can have significant benefits to the estate, and therefore to the beneficiaries of the proceeds of distribution following liquidation. There may be circumstances, such as where the contract lease price is lower than the market value, where termination of the contract may result in a windfall for the counterparty. If the contract can be continued and assigned, the insolvency estate rather than the counterparty will benefit from the difference between the contract and market prices.

111. However, this ability may undermine the contractual rights of the counterparty to the contract and raise issues of prejudice, especially where the counterparty has little or no say in the selection of the assignee. Different approaches are taken to this issue. Some insolvency laws specify that non-assignment clauses are made null and void by the commencement of insolvency proceeding. Other insolvency laws require agreement of the counterparty or of all parties to the original contract in order for the contract to be assigned or provide that if the counterparty does not consent to assignment, the insolvency representative may assign with permission from the court if it can be shown that the counterparty is withholding consent unreasonably. A further approach provides that a contract can be assigned if the insolvency representative demonstrate to the counterparty that the assignee can adequately perform the contract. The insolvency representative is then free to assign the contract for the benefit of the estate. This approach is consistent with the approach taken in the UNCITRAL [draft] Convention on the Assignment of Receivables in International Trade, article 9. While this latter option is considered of critical importance to the liquidation proceedings of some countries, in other countries it is entirely foreign and is precluded.

112. Irrespective of the powers of the insolvency representative to assign contracts, some contracts cannot be assigned because they require the performance of irreplaceable personal services or because assignment is prevented by the operation of law. Some countries, for example, prevent the assignment of government procurement contracts.

(d) General exceptions to the power to continue, terminate and assign contracts

(i) Employment contracts

113. One important exception is that of employment contracts. Although particularly relevant to reorganization, such contracts are also relevant in liquidation where the insolvency representative is attempting to sell the entity as a going concern. A higher price may be obtained if the insolvency representative is able to terminate onerous employment contracts or to achieve necessary downsizing of the labour force of the debtor. However, the relationship between employee and employer raises some of the most difficult questions in insolvency law. It is not simply the contract itself, which in essence is a pending contract like any other, but the usually mandatory provisions of non-insolvency law that protect the position of employees. These may relate to, for example, unfair dismissal; minimum rates of pay; paid leave; maximum work periods; maternity leave; equal treatment and non-discrimination. The difficult question is generally the extent to which these provisions will impact upon the insolvency, raising issues that are much broader than termination of the contract and priority of monetary claims. For these reasons, a number of countries have adopted special regimes to deal

with the protection of employees' claims in insolvency (see Claims of creditors and their treatment) and, in order to avoid insolvency proceedings being used as a means of eliminating employee protection, specifically limit the insolvency representative's ability to terminate employment contracts. This may include limiting the use of the powers to certain specified circumstances such as where the remuneration is excessive in comparison to what the average employee would receive for the same work. In some countries the law provides for employees to follow the business in case of sale as a going concern in both liquidation and reorganization, in others only in reorganization.

114. To enhance the transparency of the insolvency regime, it is desirable that the limitations on the powers of the insolvency representative to deal with these types of contracts are stated clearly in the insolvency law.

(e) Disclaimer of onerous assets

115. In addition to the power to terminate contracts, some insolvency laws provide that the insolvency representative can disclaim other assets included in the estate whenever the asset is burdened in such a way that retention would require excessive expenditure, or it is unsaleable or not readily saleable or it would give rise to an onerous obligation. As in the case of termination of a contract, the right to disclaim may be accompanied by provision for claims for damage suffered as a consequence of the disclaimer and by provisions allowing the ownership of the asset to be vested in some person other than the debtor.

(e) Setoff, netting and financial contracts[1]

(i) Setoff

116. An important issue that arises in the design of an insolvency law is the treatment of a creditor who, at the time of the application for liquidation proceedings, also happens to be a debtor of the estate. If the fundamental principle of equality of treatment of similarly situated creditors is applied, the outcome would be relatively straightforward: the insolvency representative will be able to receive the full amount owed by the creditor and the creditor's claim will be satisfied upon the liquidation of the estate. However, an alternative approach permits the creditor, in these circumstances, to exercise setoff rights against the estate after the application for liquidation is made, with the effect that, depending on the size of the estate's claim on the creditor, the creditor's claim is satisfied in full.

117. There are several reasons why it may be appropriate to include the right of setoff in an insolvency law. The first is that of fairness: notwithstanding the importance of equality of treatment among creditors, it is considered unfair for a debtor to refuse to make a payment to a creditor but, at the same time, to insist upon payment from that creditor. In addition, since many counterparties are banks, the right of setoff is particularly beneficial to the banking system and, because of the important credit creation role of banks, it is therefore considered to be of general benefit to the economy. By virtue of their core functions (lending and deposit taking) banks that have lent to an

[1] The material in this section is largely taken from "Orderly and effective insolvency procedures: Key issues", Legal Department, International Monetary Fund, 1999, pp42-44 and from the "Principles and Guidelines for Effective Insolvency and Creditor Rights Systems", The World Bank, April 2001, paras. 121-125.

insolvent debtor often find that they have financial obligations to the debtor in the form of deposits. A post-commencement right of setoff will allow the banks to offset their unpaid claims with the debtor's deposits even though these reciprocal claims are not yet due and payable. Setoff allows the creditor to escape the difficulties created by the insolvency of the debtor and thus helps to avoid the cascade effect of bankruptcy, as well as reducing exposures and transaction costs and thus the cost of credit.

118. Although there are a number of advantages to allowing setoff, these may need to be balanced against some of the arguments against a right of setoff. Insolvency setoff is a violation of the *pari passu* principle because a creditor with a setoff gets paid in full. Setoff can deplete a debtor's assets and inhibit reorganization particularly where the debtor loses access to its bank accounts or cash in its bank accounts and [*others?*].

119. The international position with regard to setoff is complex. A small number of countries do not permit setoff, except for certain transactions and for current account setoffs. A few countries have widened their transaction setoffs and introduced netting legislation which applies only to specified contracts. Among those states that traditionally permit setoff a small number impose a stay in reorganization proceedings, although permitting an exemption for financial contracts. Other insolvency laws do not address the question of setoff.

120. The right of setoff interacts with other provisions of insolvency in a number of important respects. For example, the right of a creditor to claim the benefit of a setoff will be subject to the avoidance provisions if the time of the provision or receipt of credit to or from the debtor falls within the relevant suspect period and the debtor was insolvent at that time or rendered insolvent by the setoff. It may also be subject to avoidance where it occurs after the making of the application for commencement of proceedings. Where an insolvency law generally allows termination clauses to be overridden thus allowing the insolvency representative to continue unperformed contracts, a creditor will only be able to exercise setoff rights regarding mutual monetary claims where the right to override the termination clause is expressly allows a creditor to terminate the contract and setoff these claims. This is particularly important in the context of short-term financial transactions (see ...).

(ii) Financial contracts and netting

121. Depending upon how an insolvency regime addresses issues relating to the treatment of contracts and setoff rights, it may or may not need to include provisions regarding certain types of short-term financial contracts, including derivative agreements (e.g. currency or interest rate swaps). The terms of the increasingly standardized master agreements which govern these individual transactions normally contain provisions that enable one party, upon the commencement of the insolvency of the other party, to net (see definitions) the total of all its gains and losses and all unpaid amounts on separate transactions. Such "close-out netting" provisions (see definitions), which aggregate all independent payment obligations, are normally effective only upon the insolvency of one of the parties if the insolvency law contains two features. First, it must allow for the termination (or "close-out") of all outstanding transactions under the agreement on the insolvency of a party, and second, it must allow the non-insolvent party to set off its claims against the obligations of the insolvent party.

122. The insolvency laws of a number of countries do not contain both of these features. With respect to termination, some countries allow an insolvency representative

to elect to continue the contract in contravention of the termination provisions of the contract. With respect to setoff, a number of countries do not allow for the setoff of independent financial claims that are not mature at the time of commencement.

123. Many countries that do not possess these general rules that provide for both termination and setoff, have carved out exceptions to the applicable insolvency rules for the specific purposes of allowing "close-out netting" for financial contracts. The rationale for these exceptions is the increasing importance of these transactions in the global financial market and the fact that access to such transactions would be restricted if there was no certainty regarding netting upon the insolvency of one . Notwithstanding these important advantages, it should be recognized that such "carve-outs" complicate the law and result in preferential treatment for certain types of creditors.

2. Summary and recommendations—treatment of contracts

(1) The purpose of these provisions is to:

(a) enable the insolvency representative to interfere in contracts that have not been performed or not fully performed by both the debtor and its counterparty with the objective of maximizing the value and reducing the liabilities of the estate;
(b) define the scope of the powers of the insolvency representative to interfere in contracts and the situations in which they may be exercised;
(c) identify the contracts that should be excluded from those powers;
(d) [...].

(2) An insolvency representative may terminate contracts that are not performed or not fully performed by both the debtor and the counterparty.

(3) Two approaches may be taken as to when termination may be effective:

(a) when the insolvency representative gives notice of termination [advantages and disadvantages from para. ... to be included here]; or
(b) automatically in the absence of a decision by the insolvency representative (or the court) to continue the contract within a specified period of time, where the time specified may be extended or reduced by the court [advantages and disadvantages from para. ... to be included here].

(4) Termination gives rise to an unsecured claim for the damages arising from the termination.

(5) In insolvency proceedings the right to terminate certain classes of contracts, including employment contracts, financial contracts and [...] should be limited. The powers of the insolvency representative with respect to those contracts should be stated clearly in the insolvency law.

(6) The insolvency representative may elect to continue contracts that will be beneficial to the business and add value to the insolvency estate, with the exception of financial contracts, contracts that cannot be continued because they require the debtor to perform irreplaceable personal services and [...]. Provisions on

continuation and assignment should be accompanied by compensation of the counterparty for damages caused by the default, if any.

(7) Where a provision of the contract has the effect of terminating the contract upon the commencement of insolvency proceedings:

(a) the provision may be treated by the insolvency representative or the court as null and void; or
(b) the insolvency law can provide that it is null and void; or
(c) the automatic termination clause cannot be invoked as a defence against the insolvency representative's claim for performance of the contract

(8) Contracts continued by the insolvency representative become obligations of the estate from the commencement of the proceedings.

(9) With the exception of contracts that cannot be assigned because they require performance of irreplaceable personal services or because assignment is prohibited by operation of law, the insolvency representative may treat a non-assignment clause as void and assign a continued contract subject to the agreement of all parties to the original contract.

(10) Where the parties in do not agree to the assignment, the court may nevertheless approve the assignment of the contract if it will be beneficial to the business, add value to the insolvency estate and the court finds that the assignee can perform the contractual obligations.

(11) With the exception of those classes of special contracts in respect of which the insolvency representative has limited powers, the powers of the insolvency representative with respect to termination, continuation and assignment of contracts should be exercisable without the need for approval by the court or by creditors, but would be subject to review by the court on application by an interested party.

D. Avoidance actions

1. General remarks

124. Insolvency proceedings (both liquidation and reorganization) may commence at lengthy periods after a debtor first becomes aware that such an outcome cannot be avoided. In that intervening period, there may be significant opportunities for the debtor to attempt to hide assets from creditors, incur artificial liabilities, make donations to relatives and friends, or pay certain creditors to the exclusion of others. The result of such activities, in terms of the eventual insolvency proceedings, is to disadvantage general unsecured creditors, who were not party to such actions and do not have the protection of security, and to undermine the key objective of equitable treatment of creditors.

125. Many insolvency laws include provisions which apply retrospectively and are designed to upset and overturn those past transactions to which the insolvent debtor was a party and that have had the effect of either reducing the net worth of the debtor (for example, by gifting of its assets or transferring or selling assets for less than its fair

commercial value) or of upsetting the principle of equal sharing between creditors of the same class (for example, by payment of a debt to an unsecured creditor or granting a security to a creditor who is otherwise unsecured when other unsecured creditors remain unpaid). A principal goal of avoidance powers is to ensure that creditors receive a fair allocation of an insolvent debtor's assets consistent with established priorities for payment. Notwithstanding this goal, it is important to bear in mind that many of the transactions that may be subject to avoidance powers are perfectly normal and acceptable when they occur outside an insolvency context, but become suspect only because they occurred in proximity to the commencement of insolvency proceedings.

126. Avoidance rules are much discussed, principally as to their effectiveness in practice and the somewhat arbitrary rules that are necessary to define, for example, relevant time periods and the nature of the transactions to be included. Nevertheless, avoidance provisions can be important to the insolvency law not only because the policy upon which they are based is sound, but also because they may result in recovery for the benefit of creditors generally, and because provisions of this nature help to create a code of fair commercial conduct and are part of appropriate standards for the governance of commercial entities.

127. As is the case with a number of the core provisions of an insolvency law, it is desirable to reach a balance, in designing provisions for avoidance powers, between competing social benefits. These would include the value of strong powers to maximize the value of the estate for the benefit of all creditors and the possible undermining of contractual predictability and certainty. When the balance suggests that a particular transaction is harmful, it may become legally "voidable", that is, subject to being treated as legally void, so that asset the debtor has disposed of, or its value, may be recovered by an insolvency representative for the benefit of creditors generally.

128. Different approaches are taken to defining which transactions are subject to avoidance provisions. One approach emphasizes the reliance on generalized, objective criteria for determining whether transactions are avoidable. The question would be, for example, whether the transaction took place within a specified period prior to commencement of the insolvency proceedings (often referred to as the "suspect period") or whether the transaction contains any of the general characteristics set forth in the law (e.g. requirements for provision of appropriate value). While generalized criteria may be simple to apply, they can also have arbitrary results if relied upon exclusively. So, for example, legitimate and useful transactions that fall within the specified period are voided, while fraudulent or preferential transactions that fall outside the period are protected.

129. Another approach emphasizes case-specific, subjective criteria such as whether there is evidence of intention to hide assets from creditors, whether the debtor was insolvent when the transaction was made and whether the counterparty knew of the insolvency. This individualized approach may require consideration in some detail of the intent of the parties to the transaction and what constitutes the normal course of business between them. In some countries this type of approach has led to considerable litigation and extensive cost to the insolvency estate. In order to avoid these costs (see ... below), some laws have adopted an approach of a short time limit for the suspect period, such as 3-4 months, combined with an arbitrary rule that all transactions occurring within that period would be suspect unless there was a roughly contemporaneous exchange of value between the parties to the transaction.

130. Irrespective of whether the insolvency law adopts either of these approaches or an intermediate approach which seeks to achieve a balance between the two, it is generally accepted that stricter rules should apply to transactions made to related parties (i.e. persons who have a close business or family relationship to the debtor or its creditors, sometimes referred to as an insider). A stricter regime may be justified on the basis that those parties are more likely to be favoured and tend to have the earliest knowledge of when the debtor is, in fact, insolvent.

(a) Types of transactions to be avoidable

131. The use of the word "transaction" is intended to refer generally to the wide range of means by which assets may be disposed of including by way of a transfer, a payment, a security, a guarantee, an obligation, a loan, a release or a discharge.

132. Three common types of avoidable transactions are found in most legal systems. They are: transactions intended to defraud creditors, transactions at an undervalue, and transactions with certain creditors which could be regarded as preferential. Some transactions may have the characteristics of more than one of these different classes, depending upon the individual circumstances of each contract. For example, transactions which appear to be preferential may be more in the character of fraudulent transactions when they occur while the debtor is nearly insolvent or where they leave the debtor with insufficient assets to conduct its business. Similarly, transactions at an undervalue may be preferential when they involve creditors, but not when they involve third parties. In considering categories of transactions to be avoided, an insolvency law may focus upon the consequences of the transaction and the relationship between the parties involved. The relevance of such an approach may be seen, for example, in a situation where directors of the debtor entity sought to pay off, in the period before commencement, all the liabilities that they had personally guaranteed. While the payments may appear acceptable, the effect of those payments may need to be considered.

133. These three types of transactions are made avoidable for several reasons, including: to prevent fraud (for example, transactions designed to hide assets for the later benefit of the debtor or to benefit the officers, owners or directors of the debtor); to prevent favouritism, where the debtor wishes to advantage certain creditors at the expense of the rest; to prevent a sudden loss of value from the business entity just before the supervision of the insolvency proceedings is imposed; and to create a framework for out-of-court settlement—creditors will know that last-minute transactions or seizures of assets can be set aside and therefore will be more likely to work with debtors to arrive at workable settlements without court intervention.

(i) Fraudulent transactions

134. Fraudulent transactions are those made by the debtor's management with the intent to defeat, hinder or delay the efforts of creditors to collect claims, by transferring assets beyond the reach of creditors to any third party where the third party knew of such an intent. Unlike the other transactions discussed in this section, fraudulent transactions cannot be automatically avoided by reference to an objective test of a fixed suspect period because of the need to prove the intent of the debtor. As a practical matter, in order to prove intent, if the debtor cannot explain the commercial purpose of a particular transaction which extracted value from the estate it may be relatively straight forward to show that the transaction is fraudulent. In designing an insolvency law, as noted above, it

may desirable to bear in that transactions that are potentially fraudulent under insolvency law are often perfectly valid under non-insolvency law.

(ii) Undervalued transactions

135. Transactions may be avoidable where the value received by the debtor as the result of the disposal of an asset to a third party was either nominal, or much lower than the true value of the asset disposed of and where the transaction occurred within a specified period of time before commencement of the insolvency proceedings. Some laws also require a finding that the debtor was insolvent at the time the transaction occurred, or was made insolvent as a result of the transaction. These transactions include transactions with both creditors and third parties.

(iii) Preferential transactions

136. Preferential transactions may be subject to avoidance where the transaction took place within a defined but usually rather short period before the commencement of the insolvency proceeding with a creditor on account of a debt and, as a result of the transaction, the creditor receives more than its lawful, *pro rata* share of the debtor's assets. Many countries also require evidence of insolvency or near insolvency when the transaction took place. The rationale for including these types of transactions within the scope of avoidance provisions is that when they occur very close to the commencement of proceedings, a state of insolvency is likely to exist and they breach the key objective of equitable treatment of creditors.

137. Examples of preferential transactions may include transactions made after the application for insolvency proceedings but before commencement, unless the transaction was authorized by the terms of the insolvency law. It may be desirable for the insolvency law to provide that where these transactions are unauthorized they should be void, not voidable, in order to avoid disputes. Although in some cases gifts may be entirely innocent and permitted by law, they may also be unfair to creditors and avoidable as fraudulent, undervalued or preferential transactions. A setoff, while not avoidable as such, may be considered prejudicial when it occurs within a short period of time before the application for commencement of the insolvency proceeding and has the effect of altering the balance of the debt between the parties in such a way as to create a preference or where it involves transfer or assignment of claims between creditors to build up setoffs. It may also be subject to avoidance where the setoff occurs in irregular circumstances such as where there is no contract between the parties to the setoff.

138. A defence to an allegation of a preferential transaction may be to show that although appearing to be irregular the transaction was in fact consistent with normal commercial practice and, in particular, with the normal course of business between the parties to the transaction. For example, a payment made on receipt of goods that are regularly delivered and paid for may not be avoided even if made within proximity of the commencement of insolvency proceedings, whereas payment of a long overdue debt could be avoided. This approach encourages suppliers of goods and services to continue to do business with a debtor which may be having temporary financial problems, but which is still viable.

139. Security interests valid under the laws permitting the grant of security to creditors may be avoidable in insolvency proceedings under the categories of fraudulent, preferential or undervalued transactions. For example, the grant of a security interest

shortly before insolvency, although otherwise valid, may be found to have favoured unfairly a certain creditor at the expense of the rest. Where a security interest can be granted on the basis of past consideration or of an existing debt (permitted in some legal systems, but not in others) it may also be invalid as favouring that particular creditor unfairly.

(d) Establishing the suspect period

140. Some insolvency laws explicitly specify the suspect period (for example, so many days or months before commencement of insolvency) during which each of these types of transactions would be subject to avoidance. In other laws, the suspect period is defined retrospectively by the court after proceedings have commenced. In those laws, the court's decision is often based on a finding as to when the debtor ceased paying its debts in the normal way ("cessation of payments"). A related issue is whether suspect periods stipulated in the insolvency law can be extended by the court in appropriate situations, such as where transactions which occurred outside the suspect periods in questionable circumstances had the effect of diminishing the estate. While a discretionary approach may allow a certain degree of flexibility with respect to the transactions to be caught by the avoidance provisions, it may also lead to delay in the proceedings and does not give a certain or transparent indication to creditors as to the types of transactions that are likely to be avoided. If transactions can be unwound where they took place at some unspecified time prior to the commencement of insolvency proceedings and subject to the discretion of the court, there is likely to be less safety in commercial and financial transactions.

141. Some systems may have one suspect period for all types of avoidable transactions, while others have different periods depending upon factors such as whether the injury to creditors was intentional (i.e. fraudulent) and whether the transferee was an insider (i.e. a person who has a close corporate or family relation to the debtor or its creditors). Because fraudulent transactions involve intentionally wrongful conduct, many insolvency laws do not limit the time period within which these transactions must have occurred in order for them to be avoided. Other insolvency laws establish a very long limit (examples range from one to six years) where the suspect period is calculated from the date of commencement of proceedings.

142. Where preferential and undervalued transactions involve creditors who are not insiders, the suspect period may be relatively brief, perhaps no more than several months. However, where insiders of the debtor are involved, many countries apply stricter rules. These may include longer suspect periods, shifted burdens of proof and dispensing with requirements that the debtor be either insolvent at the time of the transaction, or rendered insolvent as a result of the transaction.

(e) Liability of counterparties to voided transactions

143. With regard to each of these types of transactions, the question arises as to whether the counterparty may be exempted from liability and whether annulment of the transaction is desirable. Such a decision may be subject to different considerations for each type of transaction and will involve balancing requirements of fairness in respect to innocent parties against the difficulties of proving motive and knowledge and the harm occasioned to creditors, independent of the counterparty's state of mind.

144. In the case of fraudulent transactions, for example, the extent to which the counterparty paid adequate value and had knowledge of the debtor's actual intent to defraud creditors will be relevant. In the case of undervalued transactions, the question of whether or not the counterparty was an insider and had knowledge of the debtor's actual or imminent insolvency or that the debtor was likely to become insolvent as a result of the transaction will be relevant. Some insolvency laws permit defences such as that the counterparty to the transaction gave value, and had no knowledge of the crucial facts, while others require a return of the asset regardless, although with some protection for any value actually given by the counterparty.

145. In the case of preferential transactions, different approaches may be taken. Under one approach, where the creditor acted in good faith and had no knowledge that the debtor was insolvent at the time of the transaction or was rendered insolvent as a result of the transaction, the creditor is not subject to liability and the transaction is not annulled. Another approach provides the same result where the transaction was substantially contemporaneous with the creation of the creditor's claim, was subsequently followed by provision of value, or occurred in the ordinary course of business.

146. Where these transactions involve insiders, stricter rules may be adopted and their ability to make claims in the proceedings can be restricted or their claims may be subordinated to all other creditors.

(f) Void and voidable transactions

147. Where a transaction falls into any of these categories, insolvency laws either render it automatically void or make it voidable, depending upon the test that is adopted in respect of each category of transaction. For example, where the law refers only to transactions occurring within a certain fixed period of time and includes no subjective criteria, it can specify that those transactions will be void. Even where the transaction is void, however, the insolvency representative may have to take action to recover from the counterparty.

148. In those laws where the transaction is voidable, the insolvency representative is required to decide whether the avoidance of the transaction will be beneficial to the estate, taking into account the elements of each category of avoidable transaction as well as the delays in recovering either the assets involved or the value of the assets and the possible costs of litigation. That discretion would generally be subject to the insolvency representative's obligation to maximize the value of the estate, and it may be responsible for its failure to do so.

149. Where the insolvency representative does not take action to avoid certain transactions, insolvency laws adopt different approaches to the conduct of avoidance actions and to the manner in which they may be funded where there are insufficient assets in the insolvency estate to do so. As to the conduct of those actions, some laws permit a creditor or the creditor committee to take action to require the insolvency representative to initiate an avoidance action where it appears to be beneficial to the estate to do so or also permit a creditor itself or the creditor committee to commence an action to avoid these transactions, where other creditors agree. Where this latter action is permitted, some laws provide that assets or value recovered by the creditor are to be

treated as part of the estate; in other cases whatever is recovered can be applied in the first instance to satisfy the claim of the creditor which takes the action.

150. As to the manner in which they may be funded, some countries make public funds available to the insolvency representative to commence avoidance actions. In other countries, those actions are to be funded from the insolvency estate. This latter approach may operate to prevent the recovery of assets that have been removed from the estate with the specific intention of leaving the estate with few assets from which to fund their recovery through an avoidance action. Some insolvency laws allow the insolvency representative to assign the action for value to a third party or to approach a lender to advance funds with which to commence the avoidance action. In support of the use of the latter mechanisms, there are clearly significant differences between countries in the availability of public resources for such funding and where there is no ability to fund avoidance actions from the insolvency estate, these alternative approaches may offer, in appropriate situations, an effective means of restoring value to the estate.

(g) Evidentiary issues

151. Insolvency laws adopt different approaches to establishing the elements of an avoidance action. In some laws, the debtor is required to prove that the transaction did not fall into any category of avoidable transactions. In other laws, the insolvency representative or other person permitted to challenge the transaction, such as a creditor, is required to prove the existence of each element of an avoidance action. Some laws allow the burden of proof to be shifted where, for example, it is difficult for the insolvency representative to establish the debtor's actual intent to defraud creditors except through external indications, objective manifestations, or other circumstantial evidence of such intent. The burden of establishing the debtor's innocent motive is shifted in those laws to the counterparty to the transaction.

2. Summary and recommendations—avoidance

(1) The purpose of avoidance provisions is to:

(a) set out the circumstances in which certain transactions which occurred prior to insolvency proceedings involving the debtor may be considered injurious to creditors because they were fraudulent or violated the principle of equal treatment of creditors;
(b) enable the insolvency representative to take proceedings to avoid those transactions;
(c) enable money or assets to be recovered from other persons involved in transactions that have been avoided; and
(d) enable obligations of the debtor arising from transactions that have been avoided to be declared unenforceable.

Variant 1

(2) The insolvency representative may take proceedings in court to set aside as a void transaction:

(a) transactions intended to defeat, delay or hinder the ability of creditors to collect claims [irrespective of the time at which those

transactions occurred] [where the transaction occurred within a period of [...] years immediately preceding or after commencement of proceedings];

(b) transactions at an undervalue which occurred within a period of [...] [months][years] immediately preceding commencement of proceedings [at a time when the debtor was insolvent or if the debtor became insolvent as a result of the transaction];

(c) preferential transactions involving creditors which took place within a period of [...] months immediately preceding commencement of proceedings [at a time when the debtor was insolvent or became insolvent as a result of the transaction]

(d) undervalued transactions involving related persons or preferential transactions involving insider creditors which took place within a period of [...] [months] [years] immediately preceding commencement of proceedings [at a time when the debtor was insolvent or became insolvent as a result of the transaction].

Variant 2

(2) An alternative approach would be to provide that both undervalued and preferential transactions could be automatically avoided by reference only to a fixed suspect period.

(3) The periods of time referred to in (2) may be extended by the court.

(4) An insolvency law should specify the elements to be proven in order to establish a case for avoidance and also possible defences to that action.

(5) With respect to fraudulent transactions, two approaches may be taken:

(a) the insolvency representative is able to establish the actual intent of the debtor through external indications, objective manifestations or other circumstantial evidence; or

(b) the counterparty is required to establish the debtor's innocent motive.

(6) An insolvency law may provide alternative approaches to cover situations where the insolvency representative does not pursue avoidance actions. These may include permitting individual creditors or the creditors committee to pursue the actions or [*other measures to be included*].

(7) Transactions occurring after the commencement of proceedings should be void unless authorized by the insolvency representative or the court and the assets transferred subject to recovery.

IV. Administration of proceedings

A. Debtor's rights and obligations

1. General remarks

(a) Control of debtor's management

(i) Liquidation

152. Once liquidation proceedings have commenced, the conservation of the estate requires comprehensive measures to protect the estate not only from the actions of creditors (see above...), but also from the debtor or its managers or owners.[2] For this reason, many insolvency laws divest the debtor of all rights to manage and operate the business and appoint an insolvency representative to assume all responsibilities divested. These responsibilities may include the right to initiate and defend legal actions on behalf of the estate and the right to receive all payments directed to the debtor. Upon commencement of the liquidation proceedings, any actions taken by the debtor that are detrimental to the estate would normally be void.

153. Where it is determined that the most effective means of liquidating the estate is to sell the business as a going concern, some laws provide that the insolvency representative should supervise and have overall control of the business while permitting the debtor to enhance the value of the estate and facilitate the sale of the assets by continuing to serve and advise. This approach may be supported by the debtor's detailed knowledge of its business and the relevant market or industry, as well as its ongoing relationship with creditors. Under that approach, any transfer of the debtor's assets which occurs after commencement of proceedings and which is not authorized by the insolvency representative or the court will be void, and the assets transferred subject to recovery (see ...). The insolvency representative may be made liable for the wrongful acts of the debtor during the period of its control.

(ii) Reorganization

154. In reorganization proceedings, there is no agreed approach either on the extent to which displacement of the debtor is the most appropriate course of action or on the ongoing role that the debtor may perform. In many circumstances, the debtor will have immediate and intimate knowledge of its business and the industry within which it operates. This knowledge is particularly important in the case of individual businesses and small partnerships and may provide a basis for management to provide continuity in the business and have a role in making short term management decisions. It may also assist the insolvency representative to perform its functions with a more immediate and complete understanding of the operation of the debtor's business. For similar reasons, the debtor is often well positioned to propose a reorganization plan for approval by creditors and the

---

[2] Because the insolvency law will cover businesses that are operated by different types of entities, whether individuals, partnerships or some form of company, the question of the continuing role of the debtor properly raises questions of the role of the debtor's management or owners, depending upon the circumstances. For ease of reference, the Guide refers only to "the debtor", but it is intended that management and owners should be covered by the use of that term where appropriate.

court. In such circumstances, total displacement of the debtor, notwithstanding its role in the financial difficulties of the business, may not only eliminate the incentive for entrepreneurial activity and risk taking, as well as for debtors to commence reorganization procedures at an early stage, but also undermine the chances of success of the reorganization.

155. The desirability of the debtor having an ongoing role may need to be balanced against a number of possible disadvantages. Creditors may have a lack of confidence in the debtor on account of its financial difficulties (and the role that management may have played in that situation) and confidence will need to be rebuilt if the reorganization is to be successful. Permitting the debtor to continue to operate the business with insufficient control over its powers may not only exacerbate the breakdown of confidence but may antagonize creditors further. A system which is perceived to be excessively pro-debtor may result in creditors being apathetic about the process and unwilling to participate, which may in turn lead to problems of monitoring the conduct of the debtor where the insolvency law reuires tht role to be played by creditors. It may also encourage an adversarial approach to the insolvency process, adding to costs and delay. A debtor may have its own agenda which clashes with the objectives of the insolvency regime and in particular with the maximization of returns for creditors. The success of reorganization may depend upon instituting change that existing management may not be willing to do and upon existing management having the knowledge and experience to utilise the insolvency law to work through its financial difficulties. A related factor to be considered is whether the insolvency proceedings were commenced voluntarily or involuntarily (in which case the debtor may be hostile to creditors).

156. Insolvency laws adopt different approaches to balance these competing considerations. One option is to adopt the same approach as in liquidation, removing all control of the business from the debtor and replacing it with the insolvency representative. Displacing the debtor completely, however, may cause disruption to the business and repercussions detrimental to the operation of the business at a critical point in its survival.

157. Another approach is to establish a sharing arrangement between the debtor and the insolvency representative, where the latter supervises the activities of the debtor, approves significant transactions and the debtor continues to operate the business on a day-to-day basis. This approach may need to be supported by relatively precise rules to ensure that there is clarity as to the division of responsibility between the insolvency representative and the debtor, and certainty as to how the reorganization will proceed. It may also be supported by providing that creditors can take appropriate action to ensure the sharing arrangement is effective and efficient. Where such powers are given to creditors or the creditor committee there may be a need for measures that would prevent possible abuse by creditors seeking to frustrate the reorganization proceedings or gain improper leverage. The required degree of protection could be achieved by requiring, for example, the vote of an appropriate majority of creditors before allowing creditors to take action to seek relief from the sharing arrangement.

158. Where this approach is adopted and there is evidence of gross mismanagement or misappropriation of assets by the debtor or the goal of reorganization is no longer realistic, it may be desirable to provide for the debtor to be displaced by the court, on its own motion or on that of the insolvency representative or perhaps on that of the creditors or creditor committee.

159. A third approach is to enable the debtor to retain full control over the operation of the business, with the consequence that the court does not appoint an independent representative once the proceedings begin (known as "debtor in possession"). That approach may have the advantage of enhancing the chances of a successful reorganization if the debtor can be relied upon to carry on the business in an honest manner and obtain the trust, confidence and co-operation of creditors. There may be, however, disadvantages which include the process being used in situations where the outcome is clearly not likely to be successful, that is to delay the inevitable with the result that assets continue to be dissipated, and the possibility that management may act irresponsibly and even fraudulently during the period of control, undermining the reorganization as well as the confidence of creditors. These difficulties may be mitigated by adopting certain protections such as appointment of an insolvency representative to supervise the debtor or a mechanism that allows the court (either on its own motion or at the request of creditors) to replace the debtor with an insolvency representative or to convert the proceedings to liquidation, as well as giving the creditors a significant role in supervising or overseeing the debtor. Nevertheless, this approach is a complex one that requires detailed consideration not only because it depends upon strong governance rules and institutional capacity, but also because it affects a number of other aspects of the design of an insolvency regime.

160. To assist the debtor in carrying out its duties in relation to the proceedings generally, some laws permit the debtor to employ professionals such as accountants, attorneys, appraisers and other professionals as may be necessary, subject to authorization. In some laws, that authorization is provided by the insolvency representative, in other laws by the court or the creditors.

161. Issues to be addressed:

[*A/CN.9/504, para 94 – After discussion, the Working Group agreed that it would be advisable to draw a distinction between the period between initiation of the insolvency proceedings and the approval of the reorganization plan, on the one hand, and the period following that approval, on the other hand. It was felt that, while in the first time span it would be appropriate for legislation to set out specific rules and provide for an independent representative to be involved, a more flexible approach, giving a wider scope to party autonomy, may be advisable during the period following the approval of the plan and throughout its implementation, with a view to enhancing the chances for successful reorganization.*]

(b) Provision of information

162. To facilitate a thorough, independent assessment of the business activities of the debtor including its immediate liquidity needs and the advisability of post-commencement financing; the prospects for the long term survival of the business; and whether management is qualified to continue to lead the business, information concerning the debtor, its assets and liabilities, financial position and affairs generally will be required. To enable that assessment to be undertaken, in both types of insolvency proceedings, but particularly in reorganization proceedings, it is desirable that the debtor has a continuing obligation to disclose detailed information regarding its business and financial affairs over a substantial period, not simply the period in proximity to commencement of proceedings. That detailed information may include projections of profit and loss; details of cash flow; marketing information; industry trends; as well as

information concerning the causes or reasons for the financial situation of the debtor and disclosure of past transactions that may be capable of avoidance under the avoidance provisions of the insolvency law. Although it may not be necessary for an insolvency law to exhaustively detail the information that is to be provided, such an approach may be useful to provide guidance as to the type of information that is expected to be provided. In that regard, some laws have developed standardized information schedules that set out the specific information required. These are to be completed by the debtor (with appropriate sanctions for false or misleading information) or by an independent person or administrator.

163. To ensure that the information provided can be used for these purposes, it needs to be up to date, complete, accurate and reliable and it is desirable that the obligation requires the information to be provided as soon as possible after the commencement of the proceedings. Where the debtor can meet this obligation it may serve to enhance the confidence of creditors in the ability of the debtor to continue managing the business.

164. Where the debtor is not a natural person, the information could be supplied to the insolvency representative by officers and other relevant third parties of the debtor. An alternative approach is to require the debtor itself (where it is a natural person) or one or more of the directors of the debtor to be represented at and required to attend a main meeting of creditors to answer questions, except where this is not physically possible when directors are not located in the place in which creditors meetings may be held.

165. Often the information in question will be commercially sensitive (such as trade secrets) and it is desirable that an insolvency law include provisions to protect confidential information to prevent abuse of that information by creditors or other parties in a position to take advantage of it.

166. Where information is withheld, there may be a need for some mechanism to compel the provision of relevant information such as a "public examination" of the debtor by the court or the insolvency representative. In more serious cases of withholding of information a number of countries impose criminal sanctions.

167. In addition to the specific obligation to provide information, an insolvency law may impose on the debtor a general obligation to co-operate with and assist the insolvency representative to perform its duties.

(c) Right to be heard

168. To preserve what are regarded in some countries as fundamental rights of the debtor and to ensure its fair and impartial treatment, as well as encourage debtor confidence in the insolvency process, it is desirable that the debtor has the right to be heard in the insolvency proceedings or to participate generally in the decision making that is a necessary part of the proceedings. Such a right is consistent with international and regional agreements such as article 14 of the International Covenant on Civil and Political Rights (1976) and article 6 of the European Convention on Human Rights.

169. Where the exercise of the right may lead to formalities and costs that may impede the course of the proceedings without being of any direct benefit to the debtor, it may be desirable to limit the right to situations where the debtor has an interest in respect of both its financial situation and its personal rights. It may be the case, for example, that where the debtor is no longer available in the jurisdiction in which the proceedings are

being conducted and refuses or fails to respond to all reasonable attempts by the insolvency representative or the court to establish contact, an absolute requirement to be heard could seriously impede progress of the proceedings, if not make them impossible to undertake. While it may be desirable to provide that all reasonable efforts to allow the debtor to be heard should be made, the insolvency law may need to avoid the exercise of the right resulting in abuse which would adversely affect the proceedings.

(d) Debtors liability

170. When the business entity is solvent, management generally owes its principal obligation to the owners of the business and its relations with its creditors will be governed by their contractual agreements. When the business becomes insolvent, however, the focus changes and the creditors become the real financial stakeholders in the business, bearing the risk of any loss suffered as the debtor continues to trade. The conduct and behaviour of owners and management of a business entity is primarily a matter of law and policy outside the insolvency regime. It is not desirable that an insolvency law is used to remedy defects in that area of legal regulation or to police governance policies, although some insolvency laws may include an obligation to commence insolvency proceedings at an early stage of financial difficulty (see "Application and commencement"). If the consequence of the past conduct and behaviour of persons connected with an insolvent business entity is damage or loss to the creditors of the entity (for example, by fraud or irresponsible behaviour), it may be appropriate for an insolvency law to provide for possible recovery of the damage or loss. This may extend to the powers of inquiry and examination.

2. Summary and recommendations—debtor's rights and obligations

(1) The purpose of these provisions is to [...].

(2) In both liquidation and reorganization proceedings, the debtor should have a right to [be heard on any issue concerning the proceedings] [participate in decision-making] provided that the exercise of that right does not result in abuse of the process that would adversely affect the expeditious conduct of the proceedings.

(3) In liquidation and reorganization proceedings, the debtor's obligations should be clearly specified in the law. These could include:

(a) an obligation generally to co-operate with and assist the insolvency representative to perform its duties;
(b) an obligation to provide the court, insolvency representative and, where appropriate, the creditor committee, with current, accurate and reliable information relating to its financial position and affairs generally.

(4) Information to be provided by the debtor would include*: [a statement of assets and liabilities; as well as information concerning the causes or reasons for the financial situation of the debtor and disclosure of past transactions which may be capable of avoidance under the avoidance provisions of the insolvency law and [...]*]. Additional information of particular relevance to reorganization may include: [*projections of profit and loss; details of cash flow; marketing information; industry trends*]. The information should be provided as soon as possible after commencement of the proceedings.

(5) Where the debtor fails to provide the relevant information, the insolvency law should include alternative measures for obtaining the necessary information. These may include imposing on the debtor an obligation to submit to an examination by the insolvency representative or the court in respect of its assets and affairs.

(6) Where information provided by the debtor is commercially sensitive, the insolvency law should adopt confidentiality provisions to protect it.

(7) In liquidation proceedings, management of the [insolvency estate] [debtor] should be conducted by the insolvency representative. Where it is determined that the most effective means of liquidating the estate is to sell the business as a going concern, the insolvency representative should supervise and have overall control of the business and may engage the debtor's management to assist in the operation of the business if such engagement would be beneficial to the proceedings.

(8) In reorganization proceedings, management of the [insolvency estate] [business] may be conducted under a sharing arrangement between the debtor and the insolvency representative, where the insolvency representative supervises and has overall control of the [estate] [business] and approves significant transactions, while the debtor continues to operate the business on a day-to-day basis, but cannot dispose of assets of the insolvency estate and cannot enter into obligations that bind the estate. An insolvency law should include precise rules as to how the responsibilities of the parties to such a sharing arrangement are to be divided.

(9) Where there is a sharing arrangement between the insolvency representative and the debtor and there is evidence of gross mismanagement or misappropriation of assets by the debtor or the goal of reorganization is no longer realistic, the debtor could be displaced completely by the court on its own motion, on that of the insolvency representative or on that of the creditors or creditor committee or the proceedings converted to liquidation proceedings.

B. Insolvency representative's rights and obligations

1. General remarks

171. Insolvency laws refer to the person responsible for administering the insolvency proceedings by number of different titles, including administrators, trustees, liquidators, supervisors, receivers, curators, official or judicial managers, or commissioners. The term "insolvency representative" is used in this Guide to refer to that administrator in a broad sense without distinguishing between the different functions that may be performed. The insolvency representative may be an individual or, in some jurisdictions, a corporation or other separate legal entity. Whether appointed by creditors, the court, a government department or agency, a public or statutory authority or the debtor, the insolvency representative plays a central role in the effective implementation of the insolvency law, with certain powers over debtors and their assets and a duty to protect them and their value and ensure that the law is applied effectively and impartially.

172. Since it normally has the most information regarding the situation of the debtor, the insolvency representative is in the best position to make informed decisions about the conduct of the insolvency proceedings. That does not mean that the insolvency representative is a substitute for the court, as the court would generally be required to adjudicate disputes arising in the conduct of the proceedings and approval of the court is often required at a number of stages of the proceedings. Even in countries where the role of the court in insolvency is restricted, there is a limit to the amount of authority that would normally be conferred upon an insolvency representative.

(a) Functions to be performed by the insolvency representative

173. Insolvency laws often specify the powers and duties that the insolvency representative will be given over debtors and their assets. Although some of these duties may be more relevant to liquidation than to reorganization, they may generally include:

(i) acting as representative of the insolvency estate[3];
(ii) having the exclusive capacity to sue and be sued on behalf of the insolvencyestate;
(iii) taking all steps necessary for preserving and keeping in reasonable condition any asset in the insolvency estate;
(iv) registering rights of the estate (where registration is necessary to perfect the rights of the estate against bona fide purchasers);
(v) retaining accountants, attorneys, appraisers and other professionals as may be necessary to assist the insolvency representative in carrying out its duties;
(vi) examining the debtor and any person having had dealings with the debtor in order to investigate the financial affairs of the debtor and to establish the existence, whereabouts, extent and condition of any assets that the insolvency representative believes should be included in the insolvency estate;
(vii) applying to the court for an order requiring the delivery from any person of any asset included in the insolvency estate or restraining any person from disposing of any asset included in the insolvency estate;
(viii) examining and admitting claims and preparing a statement as to admitted and disputed claims;
(ix) responding to reasonable requests for information concerning the insolvency estate or its administration, except as restricted by the court;
(x) submitting to the court periodic reports detailing the conduct of the proceedings. The report should contain, for example, details of the assets sold during the period in question, the prices realized, the expenses of sale and such information as the court may require or the creditors' committee may reasonably require; receipts and disbursements; assets remaining to be administered.
(xi) attending meetings of creditors and the creditor committee and reporting to creditors on the insolvency estate's operation. The insolvency law may specify the details to be included in such reports;
(xii) selling the assets comprised in the insolvency estate at the best price reasonably obtainable in the market;
(xiii) closing the estate promptly, efficiently and in accordance with the best interests of the various constituencies in the case; and
(xiv) submitting a final report and accounting of the insolvency estate's administration to the court.

[3] For a definition of the use of the word "estate" in the Guide, see under Insolvency estate and the glossary.

(b) Selection and appointment of insolvency representative

174. In some jurisdictions, the court selects, appoints and supervises the insolvency representative. In other jurisdictions, a separate office or institute selects the insolvency representative after the court directs it to do so, and it is charged with the general regulation of all insolvency representatives. This approach is increasingly being adopted in insolvency laws and allows the independent appointing authority to draw upon professionals that will have the expertise and knowledge to deal with the circumstances of a particular case – be it the nature of the debtor's business or other activities; the type of assets; the market in which the debtor operates or has operated; the special knowledge required to understand the debtor's affairs; or some other special reason. A third approach allows creditors to play a role in recommending and selecting the insolvency representative to be appointed, provided that that person meets the qualifications for serving in the specific case. The approaches that rely upon the independent appointing authority and the creditor committee may serve to avoid perceptions of bias and assist in reducing the supervisory burden placed upon the courts. The choice of an independent appointing authority will depend upon the existence of an appropriate body that has both the resources and infrastructure necessary to perform the required functions.

(i) Assetless estates

175. In cases where there are no assets in the insolvency estate to fund the administration of the insolvency, some mechanism may need to be devised to resolve what should happen to the proceedings. Some insolvency laws provide for immediate termination of the procedure upon assessment of absence of assets by the court, some provide that no action should be taken, while others provide a mechanism for appointment of an insolvency representative.

176. In those countries which provide a mechanism for appointment of an insolvency representative, the insolvency representative may be a public officer or an insolvency professional appointed on the basis of a roster, which is designed to ensure a fair and ordered distribution of all insolvency cases, whether assetless or otherwise. In these cases, the administration of the assetless estate is paid for by the State. One possible disadvantage of the roster system, at least in those cases where the estate does have sufficient assets to pay for administration, is that it may not ensure the appointment of the person most qualified to conduct the particular case. That may depend, of course, upon the manner in which the roster list is compiled and the qualifications required of insolvency professionals in order to be included on that list. That disadvantage may not be perceived to be as important an issue where the estate has no assets.

(c) Qualifications

177. The insolvency representative can be selected from a number of different backgrounds such as from the ranks of the business community, from the employees of a specialized governmental agency or from a private panel of qualified persons. A related issue is whether the insolvency representative must be a natural person, or whether a legal person may also be eligible for appointment. However appointed, the complexity of many insolvency proceedings makes it desirable that the insolvency representative has knowledge of the law, is impartial and has adequate experience in commercial and financial matters. If further or more specialized knowledge is required, hired experts can always provide it. In addition to having the requisite knowledge, it

may be desirable that the insolvency representative has certain personal qualities, such as that he or she is a fit and proper person to undertake the different fiduciary duties required.

178. Different approaches are taken to the issue of qualification of the insolvency representative. Requirements that have been adopted in different countries include professional qualifications and examinations; licensing where the licensing system is administered by a government authority or professional body; specialised training courses and certification examinations; certain levels of experience (generally specified in numbers of years) in relevant areas, for example, finance and commerce; [*others?*]

179. In designing the procedures and requirements for appointment, it is desirable that a balance be achieved between stringent requirements that lead to the appointment of a highly qualified person but which may significantly restrict the pool of professionals considered to be appropriately qualified and add to the costs of the proceedings, and requirements that are too low to guarantee the quality of the service required.

180. Conflicts of interest arising from a pre-existing relationship with the debtor, a creditor, a member of the court or even with a competitor of the debtor may be sufficient in some countries to preclude the appointment of a person as an insolvency representative. In order to enhance the transparency, predictability and integrity of the insolvency system, a prospective insolvency representative should be required to disclose circumstances that may lead to such a conflict or lack of independence.

(d) Duty of care

181. The standard of care to be employed by the insolvency representative and its personal liability are important to the conduct of insolvency proceedings. The insolvency representative serves as a fiduciary in the performance of its duties, whether as a court official where it is appointed by the court or otherwise. As such, the insolvency representative may be liable for a breach of those duties. Establishing a measure for the care, diligence and skill which is owed requires a standard that will take into account the difficult circumstances in which the insolvency representative finds itself when fulfilling its duties.

182. Different approaches may be taken to setting that measure, although the measure adopted will depend upon the how the insolvency representative is appointed and the nature of the appointment (e.g. a government employee - to be further addressed). One approach may be to require the insolvency representative to observe a standard no more stringent than would be expected to apply to the debtor in undertaking its normal business activities in a state of solvency, that of a prudent person in that position. Some countries, however, may require a higher standard of prudence in such a case because the insolvency representative is dealing with the assets of someone else, not its own assets. Another approach would be one based upon an expectation that the insolvency representative act in good faith for proper purposes. [*Note to the Working Group: Is there really a difference here, or is it semantic?*] A further approach may be based upon the standard of care required in negligence. In determining the applicable standard, a balance is desirable between a standard that will ensure competent performance of the duties of the insolvency representative and one that is so stringent that it invites law suits against the insolvency representative and raises the costs of its services.

183. One means of addressing the issue of costs may be to require the insolvency representative to post a bond or provide insurance coverage against a breach of its duties. This solution, however, may not be available in all countries. In designing a solution to this issue, a balance may be desirable between controlling the costs of the service and distributing the risks of the insolvency process among the participants, rather than placing it entirely upon the insolvency representative on the basis of availability of personal indemnity insurance.

184. Where losses are sustained by the estate as a result of the actions of agents and employees of the insolvency representative, the insolvency law may need to address the liability of the insolvency representative for those actions. Some insolvency laws provide that the insolvency representative is not personally liable except where it fails to exercise the proper degree of supervision in the performance of its duties.

185. Some insolvency laws require court authorization for the insolvency representative to retain accountants, attorneys, appraisers and other professionals that may be necessary to assist the insolvency representative in carrying out its duties. Other laws do not require court authorization. It is desirable that an insolvency law establish some criteria relating to the employment of such professionals in terms of their experience, knowledge and reputation, as well as the need for their services to be of benefit to the estate. In terms of remuneration of those professionals, some laws require an application to and approval by the court, while another approach may be to require approval of the creditor body. Professionals may be paid periodically during the proceedings, or may be required to wait until the proceedings are completed.

(e) Replacement or removal

186. In the event of the death, resignation or removal of the insolvency representative, disruption of the proceedings and the delay that may be occasioned by failure to provide for succession may be avoided by providing for the appointment of a successor insolvency representative. Some insolvency laws permit the insolvency representative to be removed in certain circumstances which may include that the insolvency representative had violated or failed to comply with its legal duties under the insolvency law or had demonstrated gross incompetence or gross negligence. Different approaches provide that removal may occur on the basis of a decision of the court, acting on its own motion or at the request of an interested party, or a decision taken by an appropriate majority of unsecured creditors. Where an insolvency law provides for removal of the insolvency representative, it may also need to address issues relating to substitution and succession to either title or control (as appropriate) of the assets of the estate (see "The insolvency estate").

2. Summary and recommendations-insolvency representative's rights and obligations

(1) The purpose of these provisions is to:

(a) define the functions of the person that will play a central role in the implementation of the insolvency law;
(b) establish a mechanism for the appointment of insolvency representatives, including indicating the relevant qualifications required;
(c) providing for the liability, removal and replacement of insolvency professionals;

(d) [...].

(2) Insolvency representative may be appointed:

(a) by the court, as a provisional measure, for the period between application and commencement;
(b) [by the court] [by an independent appointing authority] [on the basis of a recommendation by the creditors committee] on commencement of the proceedings.

(3) An insolvency representative should have certain qualifications and personal qualities. These could include that they be a fit and proper person to fulfil the fiduciary obligations required of an insolvency representative, are independent and impartial, have the requisite knowledge of relevant commercial law and experience in commercial and business matters.

(4) A prospective insolvency representative should be required to disclose circumstances that may lead to a conflict of interest or lack of independence.

(5) The insolvency representative's duties [functions] [rights and obligations] with regard to liquidation and reorganization proceedings should be clearly specified in the law.

(6) An insolvency law should address the issue of the liability of the insolvency representative for failure to perform its [duties][functions].

(7) An insolvency law should address replacement and removal of the insolvency representative. The insolvency representative may be removed by the court on an application by the creditors, or the creditors' committee or by the court on its own motion for reasons such as incompetence or negligence or failure to exercise the proper degree of care in the performance of its duties.

(8) In the event of the death, resignation or removal of the insolvency representative, an insolvency law should provide for appointment of a successor insolvency representative. If the insolvency representative is vested with the title to the estate, the law should provide for succession to the [title] [control] of the assets of the estate.

C. Post-commencement financing

1. General remarks

187. The continued operation of the insolvent entity is critical for reorganization and, to a lesser extent, where the business is to be sold as a going concern in liquidation. To maintain its business activities, the debtor must have access to cash flow to enable it to pay for crucial supplies of goods and services. Where the debtor has no available funds to meet its immediate cash flow needs, an insolvency law can recognize the need for such post-commencement lending, provide authorization for it and create priority for repayment of the lender. The central issue is the scope of the power, in particular, the inducements that the insolvency representative can offer a potential creditor as a means of obtaining credit. To the extent that the solution adopted impacts the rights of existing

secured creditors or those holding an interest in assets that is prior in time, it is desirable that provisions addressing post-commencement financing are balanced against the general need to uphold commercial bargains, protect the rights and priorities of creditors and minimize the negative impact on the availability of credit, in particular secured credit.

188. Post-commencement lending is likely to come from a limited number of sources. The first is pre-insolvency lenders who have an ongoing relationship with the debtor and its business and may advance new funds in order to enhance the likelihood of recovery of their existing claims and perhaps gain additional value through the higher rates charged for the new lending. A second type of lender has no pre-insolvency connection with the business of the debtor and is likely to be motivated only by the possibility of high returns. The inducement for both types of lender is the certainty that special treatment will be accorded to post-commencement lending. For existing lenders there are the additional inducements of the ongoing relationship with the debtor and its business and the assurance that the terms of their pre-commencement lending will not be altered.

189. A number of different approaches can be taken to attracting post-commencement credit and providing security for repayment. Security can be provided on unencumbered property or a second-priority security interest provided on encumbered property. Where those approaches are either insufficient or not available, some insolvency laws provide for repayment of the loan to be given a priority over other creditors. These priorities include an administrative priority (see section Distribution priorities), which ranks ahead of the general unsecured creditors, but not ahead of a secured creditor with respect to its security, or a "super" administrative priority, which ranks ahead of administrative creditors. A further approach is to provide lenders advancing post-commencement credit with a priority that ranks ahead of all creditors, including secured creditors (sometime referred to as a "priming lien"). In countries where that type of priority is recognized, it is rarely given without the consent of the secured creditors that will be displaced. The decision to obtain credit on that basis is not therefore one that could be made solely by the court, the insolvency representative or the unsecured creditors. In some legal systems, all of these options are available.

190. Incurring unsecured trade credit is essential in any case that permits continuation of the business operations. Many insolvency laws provide that the insolvency representative can obtain that unsecured credit without approval by the court or by creditors, while other laws require approval by the court or creditors in certain circumstances. With respect to the granting of different types of priorities, such as an administrative priority, some laws provide the insolvency representative with the power of approval, while in other laws approval by the court or creditors is required in respect of some forms of priorities.

191. Issues to be addressed:

[A/CN.9/504, para. 126: [...] It was noted that a distinction needed to be drawn, in terms of the provision of finance, between the different stages of the reorganization process, such as the post-application, pre-plan and post-plan periods, with only the latter period being addressed by the plan. A question was raised as to whether the issue of post-commencement finance might not also be relevant in the case of the sale of the business in liquidation.]

2. Summary and recommendations—post-commencement finance

(1) The purpose of these provisions is to: [...].

(2) An insolvency law should recognize the need for post-commencement lending and provide authorization for it in both liquidation proceedings where the business is to be sold as a going concern and in reorganization proceedings.

(3) If the insolvency representative determines that further credit is necessary for the continued operation of the debtor or its business, the [insolvency representative] [debtor] may obtain the necessary credit and provide security over its property.

(4) To facilitate the provision of credit, the insolvency law may permit the insolvency representative to give a post-commencement creditor a priority for payment that ranks ahead of either payment of unsecured creditors (an administrative priority) or payment of administrative expenses (a super administrative priority).

(5) A security created over the assets of the debtor for post-commencement financing does not have priority ahead of any existing security over the same assets unless the insolvency representative obtains a written agreement to that effect from the holder of the existing security.

D. Creditor committees

1. General remarks

192. Creditors have a significant interest in the business once an insolvency proceeding is commenced. As a general proposition, these creditor interests are safeguarded by the appointment of an insolvency representative; however many insolvency laws provide for creditors to be directly involved in the proceedings in different ways and for a number of reasons. As the party with the primary economic stake in the outcome of the proceedings they may lose confidence in a process where key decisions are made without consulting them and by individuals that may be perceived as having limited experience, expertise or independence. In addition, creditors are often in a good position to provide advice and assistance with respect to the debtor's business and to monitor the actions of the insolvency representative, thus discouraging fraud, abuse and excessive administrative costs.

193. In cases where there is a large number of creditors, the formation of a creditor committee can provide a mechanism to facilitate creditor participation in the administration of the case, whether it is liquidation or reorganization proceedings.

(a) Involvement of creditors in decision-making process

194. There are varying possible degrees of involvement of creditors in decision-making in insolvency proceedings. In some insolvency laws, the insolvency representative makes all key decisions on uncontested general matters of administration and liquidation, with the creditors playing a marginal role and having little influence. Such an approach may be efficient where it is handled by an experienced insolvency

representative because it avoids potential delays and costs involved in managing the participation of creditors. That approach may be supported by an insolvency system that provides a high level of regulation of the process and its participants.

195. Other approaches afford creditors greater participation in the proceedings. Under some insolvency laws, in liquidation proceedings, creditors may be able to select and replace the insolvency representative, approve the temporary continuation of the business by the insolvency representative, approve private sales of assets and approve the conversion of liquidation proceedings to reorganization. In reorganization proceedings, they may perform tasks such as monitoring the activities of the business (such as where the system allows the debtor some degree of control after commencement) and of the insolvency representative, as well as proposal and approval of the reorganization plan. They may also have a role in requesting or recommending action from the court, for example, a recommendation that the reorganization be converted to liquidation or that an avoidance action be commenced by creditors. In terms of costs, the creditors may also be given a role in monitoring the remuneration of the insolvency representative.

196. In liquidation, although generally it may not be important for creditors to intervene in the process or participate in decision making, it is desirable that there is the opportunity for them to be involved as they can provide a valuable source of expert advice and information on the debtor's business, particularly where it is to be sold as a going concern. It may also be desirable for creditors to receive reports on the conduct of the liquidation to ensure their confidence in the process, as well as its transparency. In reorganization, the input of creditors is both useful and necessary, as they will generally determine whether the reorganization will be successful.

197. In order to take account of the nature and size of a particular case, it may be desirable for an insolvency law to adopt a flexible approach to the functions the committee should perform, rather than stipulating the performance of specified functions in each case. As a general proposition the committee may perform an advisory function in insolvency proceedings. In addition, it may have defined functions with respect to development of the reorganization plan and, in liquidation, the sale of significant assets, as well as participating as and when requested by the insolvency representative or the court.

198. An important issue that may need to be considered where an insolvency law allows creditors to participate actively in the process is how to overcome creditor apathy and encourage participation in the proceedings. This concern may be addressed by the overall balance that an insolvency law strikes between the different interests of the parties involved in the proceedings (see for example, considerations under Debtor's rights and obligations: Control of debtor's management) and by specific measures relating, for example, to selection of the creditors committee (see below).

(b) Composition of creditor committees

199. Different approaches are taken to the composition of creditor committees. Although creditor committees generally represent only unsecured creditors, some laws recognize that there may be cases where a separate committee of secured creditors is justified. Those systems base this approach on the fact that the interests of the different types of creditors do not always converge and the ability of secured creditors to

participate in and potentially affect the outcome of decisions by the committee may not always be appropriate or in the best interests of other creditors.

200. Other insolvency laws provide for both types of creditors to be represented on the same committee. The rationale of this approach is that since the creditor committee is responsible for participating in the decision-making process and for making important decisions, secured creditors should participate otherwise they are excluded from the making of important decisions which may affect their interests. A further approach may be for an insolvency law not to specify which creditors should be represented in a given case, but to allow creditors to choose their own representatives on the basis of willingness to serve (to address the problem of creditor apathy which is not uncommon) and to provide for enlargement or reduction of the size of the committee as required. Where the types of creditors requiring representation are too diverse to accommodate their interests within a single committee, such as may be the case for special interest groups such as tort claimants and shareholders, an insolvency law could provide for different committees to represent different interests. It is desirable, however, that this mechanism only be used in special cases, in order to avoid costs and the possibility of the creditor representation mechanism becoming unwieldy.

201. The participation of shareholders or owners of the debtor and creditors related to the debtor is controversial, especially where the creditor committee has the power to affect the rights of secured creditors or where the shareholders or owners are involved with the management of the debtor. There will be cases, however, where the shareholders have no direct knowledge of or involvement with the management of the debtor, such as where the shareholders are investors with no direct association with or access to management. In such cases, there may be compelling reasons for allowing the shareholders to participate through their own committee.

202. A similar question of participation may arise in respect of parties who purchase the claims of creditors. Such purchasers may be related to the debtor or may be third parties who have no particular interest in the business of the debtor. Third party purchases may give rise to concerns about access to sensitive, confidential information that may be of value in the secondary debt market, while insider purchases raise the question of whether the purchaser is entitled to claim the original face value of the claim or only the amount actually paid for it.

203. To address any potential problem, an insolvency law could adopt the approach of stipulating which parties are not entitled to participate in a creditor committee or vote on approval of a reorganization plan.

(c) Formation of creditors committee

204. Where the law provides for the formation of creditor committees, details of the manner in which the committee is to be formed, the scope and extent of its duties, its governance and operation, including voting eligibility and powers, quorum and conduct of meetings, as well as replacement and substitution of members are often also addressed. It may be desirable to include such provisions in an insolvency law not only to avoid disputes and ensure confidentiality, but also to provide transparent and predictable procedures.

205. To facilitate administration and oversight of the committee, some insolvency laws specify the size of the committee - generally an odd number in order to ensure the

achievement of a majority vote. Where the committee represents only unsecured creditors, membership of the committee is sometimes limited to the largest unsecured creditors. These creditors can be identified by a number of means, including requesting the debtor's managers to prepare a listing of the debtor's largest creditors. To ensure equality of treatment of creditors, it may be desirable for creditors such as those whose claims have not yet been approved and foreign creditors to be eligible for appointment to the committee.

206. A number of different approaches are taken to choosing the members of the committee. One approach is for the appointment to be made by the insolvency representative or the court or some other authorized body. This approach may be subject to perceptions of bias, and a lack of equity and transparency. Creditors may not have confidence in a system that does not encourage or allow them to play a role in selecting their own representatives and may not serve to overcome the widespread problems of creditor apathy. A further approach which may encourage both creditor confidence and participation in the insolvency process is to allow creditors to select the members of the committee.

207. To ensure that it fulfils its duty to fairly represent creditors, oversight of the committee may be desirable and could be undertaken by the insolvency representative.

(d) Duties of creditors committee

208. The creditor committee can be appointed to undertake a number of tasks including monitoring the progress of the case, consulting with other principals in the proceeding, especially an insolvency representative and the existing management of the debtor, and advising the insolvency representative on the wishes of the creditor body on issues such as the sale of significant assets and formulation of the reorganization plan. To perform its functions, the committee may require administrative and expert assistance. This can be addressed by providing that the committee can seek permission from the insolvency representative to hire a secretary and, if circumstances warrant, consultants and professionals at the expense of the insolvency estate.

209. The committee's duty would be to the general body of creditors, but it would not have any liability or fiduciary duty to the owners of the insolvent business. It may be desirable to require the committee to act in good faith and to provide that members of the committee would be immune from liability in respect of actions and decisions taken by them as members of the committee unless they were found to have acted improperly or to have breached a fiduciary duty to the creditors they represent. In considering the question of the liability of the committee, a balance may need to be struck between setting too high a level of responsibility which will promote creditor apathy and effectively discourage creditors from participating and too low a level which may lead to abuse and prevent the committee from functioning efficiently as a representative body.

(e) Voting of creditors

210. Where actions to be taken in the course of the proceedings will have a significant impact on the creditor body, it is desirable that all creditors (as opposed to just the creditor committee) are entitled to receive notice of, and to vote on, those actions. These actions may include voting to select the insolvency representative where an insolvency law provides creditors with this role; on approval of the reorganization plan; and on

other significant events such as sale of substantial assets. A number of different approaches can be taken with respect to achieving that vote, depending upon the nature of the matter to be voted upon. Some laws provide that voting should occur in person at a meeting of creditors, while other laws provide that where a large number of creditors are involved or where creditors are not local residents, voting may take place by mail or by proxy. It may also be desirable to recognize that voting may take place using electronic means.

211. Different approaches are taken to the type of vote that is required to bind creditors to different decisions. As to the types of voting systems, some insolvency laws require the vote of a supermajority of the value of the claims that actually vote in order to bind all creditors [*to which types of decisions?*], where the proportion required for a supermajority may be three-fourths or two-thirds. Another approach is to require a majority of the number of voting creditors together with a supermajority of the value.

212. In other examples, the insolvency law distinguishes between different types of decisions. Some laws require a majority in value for most decisions and for decisions such as election of removal of the insolvency representative and hiring of particular professionals by the insolvency representative, a majority in value and number is required. Other laws provide that a simple majority is sufficient on issues such as election or removal of the insolvency representative. Some laws also distinguish between matters requiring the support of both secured and unsecured creditors: secured creditors will only participate in the vote on specified matters such as selection of the insolvency representative and matters affecting their security.

2. Summary and recommendations—creditor committees

(1) The purpose of these provisions is to: [...].

(2) Where the debtor has a large number of creditors, a creditor committee may be appointed to facilitate the conduct of the insolvency proceedings. The committee would generally represent [unsecured] [and secured] creditors. Where the interests of creditors cannot properly be represented in a single committee, different committees may be appointed.

(3) In both liquidation and reorganization proceedings the creditor committee should perform a general advisory function, providing expert advice and assistance to the insolvency representative. In addition to its general advisory function, the committee should play a central role in certain defined areas, including development of the reorganization plan, the sale of significant assets and in other matters as directed by the insolvency representative or the court.

(4) To assist the committee to perform the specific functions noted in (2), the creditor committee, subject to approval by the insolvency representative, may employ specialist advisers who would be paid out of the assets of the insolvency estate.

(5) As a representative committee, members of the creditor committee should be selected by creditors on the basis of their willingness to serve. The insolvency law may stipulate that the creditor committee should consist of no more than a specified number, preferably an odd number, of unsecured [and secured] creditors [with flexibility to enlarge or reduce the size of the committee as

required to suit the needs of the particular proceedings]. [A mechanism for selection of the members of the committee would be that representatives may be selected on the basis of the majority vote of those creditors attending a meeting of creditors, with the vote based upon criteria such as value of claims and number of creditors.]

(6) Members of the committee should have a duty to act in good faith. They should be exempt from liability for actions taken by them in their capacity as members of the committee unless they are found, for example, to have acted fraudulently or to have breached their fiduciary duty to creditors. The creditor committee should have no fiduciary duty to shareholders or owners of the debtor.

(7) Where the creditor committee is required to decide upon any matter, each member of the committee should have one vote and decisions of the committee should be taken on a majority basis.

(8) A vote of the general creditor body is required in respect of [...].

E. Claims of creditors and their treatment

1. General remarks

213. There are many diverse and competing interests in an insolvency proceeding. For the most part, creditors are creditors by virtue of having entered into a legal and contractual relationship with the debtor prior to the insolvency. There are creditors, however, who have not entered into such an arrangement with the debtor, such as taxing authorities (who will often be involved in insolvency proceedings) and tort claimants (whose participation will generally be less common).

214. The rights of these creditors will be governed by a number of different laws. While many creditors may be similarly situated with respect to the kinds of claims they hold based on similar legal or contractual rights, others may have superior claims or hold superior rights. Even within the same class of creditor, there will be competing rights such as secured creditors that have better security than others. For these reasons, insolvency laws generally rank creditors by reference to their claims, an approach not inconsistent with the objective of equitable treatment. In developing these categories, it is desirable that a balance be reached between the legal and commercial rights of creditors based upon fairness and the commercial reasonableness of their relative positions, at the same time observing the objective of equality of treatment, preserving legitimate commercial expectations and fostering predictability in commercial relationships. There is, however, a limit on the extent to which these goals can be achieved, given the balance that is desirable in an insolvency law between these competing objectives and other public policy considerations. To the extent that these broader public interests compete with private interests, they may lead to a distortion of normal commercial incentives. Where these public interests are given priority, and equality of treatment based upon the classification of claims is not observed, the policy reasons for establishing that priority desirably should be clearly addressed in the insolvency law. In the absence of equality of treatment, this approach will at least provide an element of transparency and predictability in the area of claims and distribution.

215. Claims by creditors operate at two levels in insolvency proceedings—for purposes of determining which creditors may vote and how they may vote (according to the class of creditor into which they fall) and for purposes of distribution. Laws differ in the types of claims that may be made. Some laws provide that certain claims are not admitted on public policy grounds, for example, foreign tax claims, judgements obtained by fraud, fines and penalties, and gambling debts (see Excluded claims). For the purposes of determining the priority of distribution of the proceeds of the estate in liquidation, reference is generally made to the categories into which creditors have been divided. In addition to relying upon these categories based upon commercial and legal relationships between the debtor and its creditors, distribution policies also very often reflect choices that recognize important public interests.

(a) Creditors

216. Creditors of an insolvent debtor generally fall into categories of secured creditors, preferred or priority creditors, and unsecured or ordinary creditors. In some insolvency laws, account is taken of employees as a separate interest group.

(i) Secured creditors

217. Most insolvency laws draw a distinction between secured and unsecured claims, depending upon how security interests are treated in the proceedings, particularly in terms of application of the stay. Where the insolvency law provides for a secured creditor to separate its security, it will no longer have a claim unless it has surrendered its security or is undersecured (i.e. the value of its claim exceeds the value of its security) and wishes to claim for the unsecured portion. Where the security is retained for sale of the business as a going concern or in reorganization, the secured creditor will have a claim. Claims by secured creditors may be admitted on a provisional basis where there are difficulties in making a precise assessment of the value of the security at the commencement of the proceedings (see Provisional claims).

218. Many insolvency laws recognize the rights of secured creditors to have a first priority for payment of their debts from their security or its proceeds. The method of distribution to secured creditors depends on the method used to protect the secured creditor during the proceedings. If the security interest was protected by preserving the value of the security, the secured creditor generally will have a priority claim on the proceeds of its security to the extent of the value of the secured claim. Alternatively, if the security interests of the secured creditor were protected by fixing the value of the secured portion of the claim at the time of the commencement of the proceedings, the creditor generally will have a priority claim to the general proceeds with respect to that value.

219. Other insolvency laws provide that secured creditors may fall behind other interests, such as unpaid wage claims, tax claims, environmental claims and personal injury claims [*others?*]. It is desirable, however, that these types of exceptions to the first priority rule be limited to provide certainty with respect to the recovery of secured credit, thus encouraging the provision of secured credit and lowering the associated costs. A different type of exception to the priority of secured creditors may arise from the costs associated with the insolvency proceedings. Since the secured claim will be satisfied directly from the net realisation proceeds of the asset concerned, the secured creditor, unlike unsecured creditors, will not contribute to the general costs of the insolvency proceeding. It may, however, contribute to other costs directly related to it, such as the administrative expenses related to the maintenance of the security. If the insolvency

representative has expended resources in maintaining the value of the security, it may be reasonable to deduct those expenses as administrative expenses. These exceptions may also relate to priorities provided in respect of post-commencement finance, where the effect on the interests of secured creditors of any priority granted should be clear at the time the finance is obtained, particularly since it may have been approved by the secured creditors [*other reasons?*].

(ii) Administrative claims

220. Insolvency proceedings often require the assistance of professionals, such as the insolvency representative and advisors to the debtor or insolvency representative. Costs may be incurred by creditor committees and also forr the purposes of operating the business and carrying out the proceedings, including many or all post-commencement debts, such as claims of employees, lease costs and similar claims. These expenses of the insolvency proceeding often have a priority, as administrative claims, over unsecured claims, and are treated differently from other claims to ensure proper payment for the parties dealing with the insolvency proceedings.

221. Notwithstanding the importance of providing appropriate remuneration to those involved in the conduct of the insolvency proceedings, administrative expenses have the potential for a significant impact on the value of the insolvency estate. While to some extent that impact will depend upon the design of an insolvency law and its supporting infrastructure, consideration of how that impact can be minimised may be desirable. An insolvency law can provide, for example, precise but flexible criteria relating to the allowance of those expenses. These criteria may include providing that allowance of the expenses is conditional upon the utility of the expense to increasing the value of the estate for the general benefit of all constituents, or that the expenses be not only reasonable and necessary, but also consistent with the key objectives of the process. Reasonableness of the expense may be assessed by reference to the amount of resources available to the proceedings and to the possible effect of the expense on the proceedings. [*Note to the Working Group: Are there examples of laws which include such criteria?*]

222. Different approaches may be taken to conducting that assessment. One approach may be to require authorization by the court prior to the cost being incurred, or authorization by the court of all costs falling outside the scope of the ordinary course of business. A second approach may be to provide that the assessment be made by creditors, to facilitate the transparency of the proceedings, subject to recourse to the court in the event that the assessment of the creditors is disputed.

(iii) Priority or preferential creditors

223. Insolvency laws often attribute priority rights to certain (mainly unsecured) claims which will in consequence be paid in priority to other, unsecured and non-preferential (or less preferential) claims. These priority rights militate against the principle of *pari passu* distribution and generally operate to the detriment of ordinary, unsecured debts by reducing the assets available for distribution. They also have the potential to foster unproductive debate on the assessment of privileges attaching to the various types of priority claims.

224. Many different approaches are taken to the types of claims that will have priority and what that priority will be. The types of priorities provided by countries vary, but two

categories are particularly prevalent. The first type provides priority for employee salaries and benefits (social security and pension claims), an approach generally consistent with the special protection that is afforded to employees in other areas of insolvency law (see below). The second type relates to government tax claims. Affording a priority to tax claims can compromise the uniform enforcement of tax laws and may constitute a form of state subsidy which can undermine the discipline that an effective insolvency regime is designed to support. [*Other examples?*]

225. In some recent insolvency laws there has been a significant reduction in the number of these types of priority rights, reflecting a change in the public acceptability of such preferential treatment. In other countries, however, there is a tendency to increase the categories of debt that enjoy priority. Maintaining a number of different priority positions for many types of claims has the potential to complicate the basic goals of the insolvency process and to make the achievement of an efficient and effective process difficult. It may create inequities and, in reorganization, complicates preparation of the plan. In addition, it should be remembered that adjusting the distribution priorities to create these priorities will not increase the total amount of funds available for creditors. It will only result in a benefit to one group of creditors at the expense of another group. The larger the number of preferred categories of priority creditors, the greater the scope for other groups to claim that they also deserve preferential treatment. The greater the number of creditors receiving preferential treatment, the less beneficial it becomes.

226. Some priorities raise issues that may be better addressed by non-insolvency law rather than designing an insolvency law to achieve social objectives which are only indirectly related to questions of debt and insolvency. Where priorities are to be included in an insolvency law or priorities exist in other laws which will affect the operation of the insolvency law, it is desirable that those priorities be clearly stated or referred to in the insolvency law. This will ensure that the insolvency regime is at least certain, transparent and predictable as to its impact on creditors and will enable lenders to more accurately assess the risks associated with lending.

(iv) Ordinary unsecured creditors

227. Once all secured and prioruty creditors have had their claims satisfied the balance generally would be distributed *pro rata* to ordinary unsecured creditors. There may be subdivisions within the class, with some claims being treated as subordinate. Some countries subordinate claims such as gratuities, fines and penalties, shareholder loans and post-petition interest to general unsecured claims, while in others some of these claims are treated as excluded claims.

(v) Employees

228. As an essential part of a business, the rights of employees often compete with those of other creditors. As a class, employees tend to fall between the extremes of owners and managers and lenders or creditors, with their relationship to the debtor based on an implicit commitment that their work will be paid for and, where they work effectively, their employment will be continued. This commitment is necessarily qualified in cases of insolvency, but many insolvency laws recognize the importance of the commitment and afford priority for outstanding wages over some other classes of creditors (see also Treatment of contracts).

229. At a broader level, the employment relationship raises other issues that typically are difficult to resolve and brings employee interests into competition with the interests of other creditors, with a potential impact upon the availability and cost of credit, especially for labour-intensive businesses. Some of these issues may arise in situations where workers have little job mobility, where unemployment is endemic, where pension and security benefits depend upon the continuation of the business or are vested in the stock of the debtor, where there is a weak social safety net for workers and [...].

230. Where employees wages are protected by special (employee) funds, the course of the insolvency is unlikely to be altered unless the claims of the fund guaranteeing those claims is excluded from making a claim in the insolvency or if those claims do not have the same priority as the employees would have had. Usual practice would be for the fund to enjoy the same rights as the employee, as least in respect of a certain specified amount which may be denoted in terms of amount of wages or weeks of pay.

231. Issues to be addressed:

[WG Report A/CN.9/504, para. 153: In respect of the privilege granted to employee salaries and benefits, it was observed that providing for a system of social guarantee would result in a benefit for the insolvency estate, since that would allow those claims to be excluded from the distribution of the assets. It was however clarified that that would require that the social institution guaranteeing those claims would not be allowed to have the same priority vis-à-vis the insolvency estate as the employees. Another view was that the draft Guide should draw attention to solutions available in different legal systems.]

(vi) Owners

232. Many insolvency laws adopt the general rule that the owners of the business are not entitled to a distribution of the proceeds of assets until the creditors, who are senior in priority, have been fully repaid. This may or may not require the payment of interest. Where a distribution is made, it would be in accordance with the ranking of shares specified in the company law and corporate charter.

(vii) Related party creditors

233. A further category of creditors that may require special consideration is those persons related to the debtor, whether in a familial or business capacity. Special treatment may be justified on the basis that these parties are more likely to have been favoured and tend to have had early knowledge of the financial difficulties of the debtor and [*other?*]. While they do not properly fall within classes of excluded claims, it may be appropriate to consider whether they should be treated in the same way as other creditors or subject to special treatment, such as subordinating their claims to those of other creditors and preventing the related creditor from voting with other creditors on approval of the plan and other key issues.

(b) Creditor claims

(i) Making of claims

234. As a general principle, claims can only be made in respect of debt incurred prior to commencement. How debt incurred after commencement is treated will depend on the

nature of the proceedings and what is provided in the insolvency law – many laws provide that they are payable in full as costs of the proceedings.

235. Different mechanisms may be used for making claims. Many insolvency laws place the burden upon creditors to produce evidence of their claims to the insolvency representative (which under some reorganization laws may be the debtor) for its review. Some laws provide that, as an initial step, a list of creditors and claims is prepared, either by the court or by the debtor. Preparation of such a list by the debtor takes advantage of the knowledge the debtor will have about its creditors and their claims and gives the insolvency representative an early indication of the state of the business. An alternative approach would be for the insolvency representative to prepare that list, an approach that may serve to reduce the formalities associated with the process of verification of claims, but may add to expense and delay. Once the list is prepared, creditors would be invited to make their claims to the insolvency representative for purposes of verification. A mechanism which requires creditors to make their claims to the insolvency representative and the insolvency representative to verify them may assist in ensuring proper distribution.

236. To ensure that claims are made in a timely fashion and that the insolvency proceedings are not unnecessarily prolonged, deadlines for submitting claims with the insolvency representative can be included in an insolvency law. Such deadlines, however, may operate to disadvantage foreign creditors who in many cases may not be able to meet the same deadlines as domestic creditors. To ensure the equal treatment of domestic and foreign creditors, and to take account of the international trend of abolishing discrimination based upon the nationality of the creditor, it may be possible to adopt an approach that either allows claims to be made at any time prior to distribution, or sets a time limit which can be extended or waived where a creditor has good reason for not complying with the deadline or the deadline operates as a serious impediment to a creditor. Where the claim is submitted late and causes costs to be incurred, the costs should be borne by the creditor.

237. To enable claims to be made in a timely fashion, it is desirable that the insolvency law require provision of adequate notice to creditors, both domestic and foreign, of the commencement of proceedings. With regard to foreign creditors, the Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency notes, in respect of article 14, that a number of the formalities required for serving notice on these creditors are cumbersome and time-consuming and their use would typically not provide foreign creditors with timely notice concerning insolvency proceedings. The Guide to Enactment recommends that these procedures should not be required, except where they may relate to an international treaty obligation (paragraphs 106-111 of the Guide to Enactment).

238. A further issue of particular importance to foreign creditors is whether the claim must be submitted in the language of the jurisdiction in which the insolvency proceedings have commenced, and whether the claim is subject to certain formalities, such as notarization and translation. To facilitate the access of foreign creditors, consideration may be given to whether these requirements are essential or may be relaxed as in the case of other procedural formalities discussed in respect of article 14 of the Model Law.

239. Most laws provide that all identified and identifiable creditors are entitled to receive notice of claims that have been made. That notification may be given personally or by publishing notices in appropriate commercial publications. An insolvency

representative may additionally be required to prepare a list of claims, both admitted and disputed, and file it with the court or other administrative body to facilitate the provision of notice to unknown creditors and provide updated information on progress with regard to admission or rejection of disputed claims.

(ii) Provisional claims

240. Creditors claims may be of two types: those that involve a determined amount and those where the amount owed by the debtor has not been or cannot presently be determined. Such claims may be either contractual or non-contractual in nature and may arise in respect of both secured and unsecured claims. Where the amount of the claim cannot be or has not been ascertained at the time the claim is to be made to the insolvency representative, many laws provide for a claim to be made provisionally or to be given a provisional value. Admission of provisional claims raises a number of issues. These concern valuation of the claim and the party to undertake that valuation (the insolvency representative, the court or some other appointed person); voting of provisional creditors on important issues such as determining whether the case is one of liquidation or reorganization or approval of the reorganization plan (see Creditor committees); and whether, as minority creditors, they can be bound by a plan to which they have not agreed (see "Reorganization plan").

(iv) Verification of claims

241. Verification involves not only an assessment of the underlying legitimacy and amount of the claim, but also a determination of the category within which a claim fits for purposes of voting and distribution (e.g. secured as opposed to unsecured claims; pre-commencement as opposed to post-commencement claims).

242. Many insolvency laws provide for the insolvency representative to verify the claims of the creditors, with disputes to be resolved by the court. It may be suggested, however, that an approach which relies heavily upon the discretion of the insolvency representative may lead to delay or even collusion with the debtor, thus undermining the predictability of the system. If that approach is adopted, however, it is desirable that the insolvency representative be required to give reasons for rejecting a claim, preferably in writing. Such a procedure is likely to enhance the transparency of the procedure and potentially its predictability. A second approach would be to provide that the court would verify all claims and resolve disputes. That approach also has the potential to lead to significant delay at a time when it may be crucial to ensure that proceedings are conducted quickly and efficiently, and will require the use of significant resources of the court.

243. An alternative approach may be to provide that claims outstanding at the time of commencement do not require verification and can be admitted on an automatic basis unless the claim is challenged. If that approach is adopted, it may be desirable to combine it with a mechanism aimed at ensuring that adequate information as to the claims admitted on that basis is available to all interested parties. Automatic admission of claims may avoid many of the difficulties associated with the insolvency representative having to make a precise assessment of the situation at the outset of the proceedings to enable creditors to participate in and vote at meetings held at an early stage of the proceedings. Automatic admission of claims may be assisted by requiring claims to be made in the form of a declaration, such as an affidavit, to which sanctions would attach in the event of fraud. It could also be assisted by admitting claims that are supported by properly maintained accounting records.

244. Admission of a claim of a creditor will establish the right of the creditor to attend and the amount for which the creditor is entitled to vote at a meeting of creditors or for the purposes of voting on the election of an insolvency representative or approval of a reorganization plan and the amount that the insolvency representative must take into account in making payment to the creditor in a distribution to creditors.

245. Where the insolvency law allows a claim to be challenged, it may also indicate which parties are entitled to initiate a challenge. Some laws allow claims to be disputed only by the insolvency representative, while other laws permit other interested parties, including creditors, to challenge a claim. To avoid a situation where there may be a significant number of claims challenged by creditors, it may be desirable to provide for final review of the list of creditors' claims at a creditors' meeting, following preparation of the list. Where disputes as to claims arise, whether between a creditor and the insolvency representative or the debtor and the insolvency representative, and including disputes as to security or security rights, a mechanism for quick resolution is essential to ensure efficient and orderly progress of the proceedings. If disputed claims cannot be quickly and efficiently resolved, the ability to dispute a claim may be used to frustrate the proceedings and create unnecessary delay.

(v) Excluded claims

246. For a variety of public policy reasons, an insolvency law may seek to exclude certain types of claims. Such claims may include foreign tax claims, fines and penalties, and gambling debts.

247. Foreign tax claims are currently excluded by many countries, and it is generally recognized that such an exclusion does not violate the objective of equal treatment of foreign and domestic creditors. Despite this general view, however, there are no compelling reasons why such claims cannot be admitted if a country wishes to do so. Where foreign tax claims are admitted, they can be treated in the same manner as domestic tax claims or as general unsecured claims. Article 13 of the UNCITRAL Model Law on Cross-Border Insolvency, recognizes these different approaches, providing that the requirement of equal treatment of foreign and domestic creditors is not affected by the exclusion of foreign tax and social security claims or by their ranking with general non-preference claim or lower if equivalent local claims have a lower ranking.

248. Where gambling debts are treated as excluded claims it is generally on the basis that they arise from an activity that is itself illegal. Rather than focussing upon the specific types of claims that may be excluded as illegal, an insolvency law may exclude, as a general category, those claims that arise from illegal activity and are thus unenforceable.

249. With respect to fines and penalties, an insolvency law may distinguish between those which are of a strictly administrative or punitive nature (such as a fine imposed as the result of an administrative or criminal violation) and those of a compensatory nature. It may be argued that the first category should be excluded on the basis that they arise from some wrongdoing on the part of the debtor and unsecured creditors should not be made to bear the burden of that wrongdoing by seeing a reduction in the assets available for distribution. In comparison, there would seem to be no compelling reason for excluding the second category, particularly where it relates to recompense for damage

suffered by another party, except to the extent that exclusion may also be justified as a means of increasing the assets available to unsecured creditors. An alternative approach would be to admit claims based on fines and penalties because otherwise they will remain uncollected [*other reasons?*].

(vi) Conversion of foreign currency claims

250. The valuation of claims is of particular relevance to foreign creditors who will generally make their claims in currencies other than that of the country of the insolvency proceedings. For verification and distribution purposes, these claims are normally converted into the domestic currency. If the date of conversion is set at the date of commencement of the insolvency proceedings, and the currency depreciates or appreciates in the period before distribution (which could occur at a significantly later time), the amount of the claim will also fluctuate. An alternative approach is to make a provisional conversion at the time of commencement for the purposes of voting, but if the exchange rate fluctuates more than a given percentage in the period before distribution, then the conversion can be made at the time of distribution.

(vii) Assignment of claims

251. [...]

252. Issues to be addressed:

[WG Report A/CN.9/504 para. 117: With respect to the treatment of loans granted by shareholders, a view was that those loans deserved a regime which took into account the specific reasons usually underlying their issuance, which would not necessarily be the same as in the case of loans by other entities. As a general remark, it was pointed out that the draft Guide should make national legislators mindful of the possible implications of legislative choices at a corporate governance level.

118. The suggestion that the draft Guide should address the issue of the treatment of joint obligations under insolvency law received significant support. In particular, it was suggested that it should address whether and to what extent the commencement of the insolvency proceeding would affect the right of a creditor to enforce the claim against one or more joint debtors other than the one subject to the proceeding. In that respect, a further view was that treatment of guarantors should be included in the draft Guide and that the situation where the guarantor was also insolvent should be addressed.

119. A further view was that the draft Guide should recommend to specifically address the issue of treatment of unsecured claims acquired after commencement of the insolvency proceedings by outlining the different approaches available under various legal systems.]

2. Summary and recommendations—creditor claims

(1) The purpose of provisions on creditor claims is to:

(a) provide for persons who claim a debt or liability against an insolvent debtor to submit their claims for consideration by the insolvency representative;

(b) require the insolvency representative to consider claims and to admit or reject them , in full or in part, and to provide for appeals from that process;

(c) provide for the treatment of particular claims, including those of secured creditors, foreign creditors, creditors whose claims are in a foreign currency, claims for interest, and claims in respect of non-matured liabilities;

(d) provide for an order of priority in the payment of claims of creditors;

(e) provide for the application of the same rules in respect of the above objectives both in a case of liquidation and a case of reorganization.

(2) All creditors, both domestic and foreign, should be notified of the commencement of proceedings and the time allowed for the making of claims. Notice should be given in a manner consistent with the requirements of article 14 UNCITRAL Model Law on Cross-Border Insolvency.

(3) Claims may be made within a specified time after the commencement of proceedings [notice of commencement of proceedings] or at any time prior to distribution.

(4) To facilitate the processing of claims, the insolvency representative should prepare a list of creditors and a statement of claims.

(5) Each [unsecured] [and secured] creditor is entitled to make a claim against the insolvency estate [within [... days] after commencement of insolvency proceedings] [at any time before distribution]. Where an insolvency law adopts a time limit for the making of claims, that time limit should be capable of extension or waiver by the court. A claim by a foreign creditor should be treated in the same way as any other claim. Claims by secured creditors should only be made where the creditor has surrendered its security or is undersecured (i.e. the value of its claim exceeds the value of its security) and wishes to claim for the unsecured portion.

(6) Certain claims may be excluded. These may include claims arising from activities that are illegal (such as gambling debts) and [foreign revenue claims], [fines and penalties], [*others?*].

(7) A creditor may make a claim by producing evidence of its claim to the insolvency representative in the form of a [declaration][affidavit].

(8) The insolvency representative will admit or reject any claim in full or in part or claims can be admitted automatically [on the basis of accounting records] unless contested by [a creditor] [the insolvency representative]. Where the insolvency representative rejects a claim it should be required to give reasons for

the rejection. Creditors whose claims have been rejected or disputed should have a right of appeal to the court.

(9) Claims of undetermined value, secured claims and disputed claims should be provisionally admitted pending valuation of the claim or security and resolution of the dispute by the court. Valuation of a claim may be undertaken by the insolvency representative or by the court. Creditors should be able to appeal against a valuation to the court.

(10) Admission of a claim of a creditor establishes:

(a) the right of the creditor to attend and the amount for which the creditor is entitled to vote at a meeting of creditor of an insolvency debtor or for the purposes of voting on the election of an insolvency representative or approval of a reorganization plan; and
(b) the amount that the insolvency representative must take into account in making payment to the creditor in a distribution to creditors.

(11) Right to setoff

(12) Claims by insiders and shareholders

V. Liquidation and distribution

A. Distribution priorities

1. General remarks

253. Distribution of the proceeds of the estate will generally be made according to the ranking of creditors by category and the different priorities accorded to those categories.

254. Where there are a number of different categories with different priorities, each level of priority will be paid in full before the next level is paid. Once a priority is reached where there are insufficient funds to pay all the creditors in full, the creditors of that priority share *pro rata*. In some laws which do not have different levels of priority, all the creditors share *pro rata* if there are insufficient funds to pay them in full.

255. It may be desirable to provide in reorganization proceedings that priority claims must be paid in full as a predicate to confirmation of a plan unless the affected priority creditors agree otherwise. A plan of reorganization may propose distribution priorities that are different to those provided by the insolvency law, provided that creditors voting on the plan approve such a modification.

2. Summary and recommendations—distribution

(1) The purpose of these provisions is to: [...].

(2) The amount available for distribution to creditors would be paid in the following order:

(a) [Secured claims]
(b) Expenses and remuneration in connection with the appointment, duties and functions of the insolvency representative;
(c) Administrative expenses;
(d) [other approved claims].

(3) The claims in each of these classes are ranked equally between themselves. All the claims in a particular class will be paid in full before the next class is paid. If there is insufficient funds to pay them in full they will be paid in proportion.

B. Discharge

1. General Remarks

256. Following distribution it is likely that a number of creditors will not have been paid in full. An insolvency law will need to consider whether these creditors will still have an outstanding claim against the debtor or, alternatively, the debtor will be released or "discharged" from those residual claims.

257. When the insolvency entity is a limited liability company, the question of discharge following liquidation does not arise; either the law provides for the disappearance of the juridical entity or, alternatively, the entity merely continues to exist as a shell with no assets. The shareholders will not be liable for the residual claims and the issue of their discharge does not arise. It does arise, however, in the context of reorganization and should be addressed. If the business entity takes a different form, such as an individual (sole proprietorship), a group of individuals (a partnership), or an entity whose owners have unlimited liability, the question arises as to whether these individuals will still be personally liable for the unsatisfied claims following liquidation.

258. Insolvency laws adopt different approaches to the question of discharge. In some, the debtor is still liable for unsatisfied claims, subject to any law as to limitations. This types of rule emphasizes the value of a debtor-creditor relationship: the continued responsibility of the debtor following liquidation serves to both moderate a debtor's financial behaviour and encourage a creditor to provide financing. Other insolvency laws provide for a complete discharge of an honest, non-fraudulent debtor immediately following liquidation. This approach emphasizes the benefit of the "fresh start" that discharge brings and is often designed to encourage the development of an entrepreneurial class. It is also a recognition that over indebtedness is a current economic reality. A third approach attempts to strike a compromise: discharge is granted after a period following distribution, during which the debtor is expected to make a good faith effort to satisfy its obligations.

259. In some circumstances, it may be appropriate to limit the availability of discharge. These may include where the debtor has acted fraudulently, engaged in criminal activity, violated employment or environmental laws and [*others?*]. In some of the countries where a discharge is given, certain debts may be excluded, such as those arising from maintenance agreements, fraud, court fines and taxes. Conditions may also be imposed upon the debtor, both during the proceedings or as a condition for a discharge, either by way of recommendation by the insolvency representative or by the court. These conditions may include restrictions on the ability to obtain new credit, to leave the country or to carry

on business for a certain period or time. Other limitations relate to the number of times a debtor can be discharged. In some jurisdictions, a discharge is a once in a lifetime opportunity; in others there is a minimum waiting period, for example, ten years, before a debtor will qualify for a new discharge, or even be able to enter insolvency proceedings which may lead to a new discharge.

260. One issue that may need to be taken into account in considering discharge of individuals engaged in a business undertaking is the intersection of business indebtedness with consumer indebtedness. Recognizing that different approaches are taken to the insolvency of natural persons (in some countries a natural person cannot be declared bankrupt at all, in others there is a requirement for the individual to have acted in the capacity of a "merchant") and that many countries do not have a developed consumer insolvency system, a number of countries do have insolvency laws that seek to distinguish between those who are simply consumer debtors and those whose liabilities arise from small businesses. In many cases, for example, consumer credit is used to finance small business either as start-up capital or for operating funds and it may be difficult to separate the debts into clear categories. For that reason, where a legal system recognizes individual consumer and business debt, it is not feasible to have rules on the business debts of individuals that differ from the rules applicable to consumer debts.

2. Summary and recommendations-discharge

(1) Where an insolvency law allows the insolvency of individuals engaged in business activity, provision should be made for the debtor to be discharged following liquidation. That discharge should be [complete and immediate where the debtor is honest and non-fraudulent] [subject to a particular time limit] [*other?*].

VI. Reorganization plans

1. General remarks

261. Insolvency laws address a number of issues in the context of formulation of a reorganization plan, such as the nature or form of the plan; when the plan is to be prepared; who is able to prepare the plan; what is to be included in the plan; how the plan is to be approved and the effect of the plan.

262. Reorganization plans perform different functions in different types of proceedings. In some the plan may be the tailpiece of the reorganization proceedings, dealing with the pay-out of a dividend in full and final settlement of all claims (also referred to as a composition or a scheme of arrangement) or it may be proposed at the commencement of the proceedings and set out the way the debtor and the business should be dealt with during the reorganization period, much like business plan, as well as setting out expected dividends and dates of payment. There may also be circumstances where a plan like a plan of reorganization is prepared in a liquidation where the business is to be sold as going concern. That plan would be much like a business plan, and would not address any matters relating to distribution as this would be handled according to the insolvency law.

(a) Nature or form of a plan

263. The purpose of reorganization is to maximize the possible eventual return to creditors and provide a better result than if the debtor were to be liquidated. With different constituents involved in the reorganization process, each may have different views of how that objective can be reached, for example, through continued business with a major customer or supplier as opposed to rapid repayment, and varying levels of risk tolerance. Some creditors may prefer an equity stake in the business, while others will not. Typically therefore, there is a range of options from which to select in a given case and if an insolvency law adopts a prescriptive approach to the range of options available or to the choice to be made in a particular case, is likely to circumvent achievement of the goal of maximizing value. It is desirable that the law should not, for example, permit only a plan that is designed to fully rehabilitate the debtor; nor provide that debt cannot be written off; nor provide that a minimum amount must eventually be paid to creditors. The determination of what is the most appropriate commercial solution may best be left to the market place.

264. An insolvency law may wish to establish some limits, such as that the priorities afforded to creditors in liquidation be maintained in reorganization, and that the effect of the plan should not be such that it could result in the debtor remaining insolvent and being returned to the market place in that condition. A non-intrusive approach would result in flexibility sufficient to allow the most suitable (in terms of the particular entity) of a range of possibilities to be chosen. Some insolvency laws adopt an approach of listing some of the possibilities that may be adopted, but it not intended that the list be exclusive of other approaches. These possibilities could include a choice of a simple composition (an agreement to pay creditors a percentage of their claims); the continued trading of the business and its eventual sale as a going concern (and for the debtor to then be liquidated); transfer of all or part of the assets of the estate to one or more existing entities or entities that will be established; a merger or consolidation of the debtor with one or more other entities; a sophisticated form of restructuring of debt and equity or some other solution.

(b) Preparation of a plan

265. Two important issues to be considered in relation to preparation of a reorganization plan are the stage of the proceedings at which it should be prepared and the party that should be responsible for its preparation. A number of different approaches can be taken to each of those issues.

266. As to the first issue, the approach depends upon the purpose or objective of the particular reorganization. Some laws adopt the approach that the plan for reorganization forms a part of the application for reorganization proceedings (where the application may be called a "proposal" for reorganization), while other laws provide for it to be prepared after commencement of reorganization proceedings. One potential difficulty with preparation of the plan before commencement of the proceedings is that, if it has been prepared without consultation with creditors and other interested parties, it may not be a plan that could feasibly be implemented and could thus operate to pre-empt the proceedings and cause delay.

267. With regard to the second issue, different participants in the reorganization proceedings may have primary responsibility for preparation of the reorganization plan, depending upon the manner in which the insolvency law is designed and in particular the respective roles assigned to the insolvency representative, debtor and creditors. In

some insolvency laws, these parties have a positive obligation to co-operate in preparing the plan. In determining which party should have primary responsibility for preparing the plan, a balance may be desirable between the freedom accorded to the different parties to prepare the plan, and the restraints necessarily attached to the process in terms of approval (voting) requirements, time limits for preparation, amendment of the plan and other procedural considerations. A flexible approach, as opposed to a regulatory approach, is likely to ensure that this balance is achieved, although in the interests of efficiency, certainty and predictability, it is desirable that an insolvency law take some steps to address these issues.

268. Some insolvency laws require the debtor to prepare the reorganization plan. This approach may have the advantages of encouraging debtors to commence reorganization proceedings at an early and making the best use of the debtor's familiarity with its business and knowledge of the steps necessary to make the insolvent entity viable (although the freedom accorded to the debtor may need to be balanced against the need to ensure creditor confidence in the debtor and its proposal). The opportunity provided to the debtor could be made exclusive or exclusive for a specified period, with the court having the power to extend the period if it will be of advantage to the reorganization proceedings. Where the plan is to be prepared before commencement, it could only be prepared by the debtor, as creditors would lack both the information and the organizational structure to do so and no insolvency representative would have been appointed.

269. Since the plan will only be successful if it is approved by a requisite majority of creditors, there is always a risk that reorganization will fail if the plan presented by the debtor is not acceptable. For example, creditors may only wish to approve a plan that deprives the debtor's shareholders of a controlling equity interest in the insolvent entity and may also deprive the incumbent management of any management responsibilities. If the debtor is given the exclusive opportunity to prepare the plan and refuses to consider such an arrangement, there is a danger that the reorganization will fail, to the detriment of the creditors, the employees, and the insolvent entity. To address that concern, some insolvency laws provide that, if the debtor fails to provide an acceptable plan before the end of an exclusive period, the creditors are given the opportunity to propose a plan (which could be achieved through a creditor committee (see "Creditor committees")). This option may provide the leverage necessary to reach a compromise between the participating parties.

270. A third approach would be to give the insolvency representative an opportunity to prepare the plan, whether as an alternative to preparation by the debtor or the creditors or as a supplementary measure. Given that the insolvency representative will have had the opportunity to become knowledgeable about the debtor's business, it will be well placed to determine what measures are necessary for the business to be viable. The importance of providing for participation by the insolvency representative or the creditors depends upon the design of the law. In circumstances where approval by the requisite majority of creditors is a necessary condition for effectiveness of the plan, a plan that takes account of proposals that will be acceptable to creditors has a greater likelihood of being approved than one which does not. This consideration will not apply where creditor approval is not necessary or can be overruled by the court. While a number of parties may be given the opportunity to prepare a plan, it is generally not desirable that a number of plans be prepared simultaneously. Although this may complicate the process and lead to inefficiency, in some cases it may also promote the preparation of a mutually acceptable plan.

271. Some laws provide for the court to consider the opinions of third parties on the plan, such as governmental agencies and labour unions. Although in particular cases this may assist in the preparation of an acceptable plan, it also has the potential to lengthen the duration of the process, and may be desirable only if it is likely to be beneficial in a particular case, and the process is carefully monitored and time limits are specified.

(c) Content

272. Most countries have laws requiring that the reorganization plan adequately and clearly disclose to all parties information regarding both the financial condition of the insolvent entity and the transformation of legal rights that is being proposed in the plan. Information as to the financial situation of the debtor may include asset and liability and cash flow statements; details of the precise proposals included in the plan; details of what creditors would receive (and how that would be more than they would otherwise receive in liquidation); and the basis upon which the business would be able to keep trading and could be successfully reorganized. Information relating to the proposals to be included in the plan may include: details of distribution of funds; the continuation or termination of contracts that are not fully executed and non-expired leases; the settlement of claims; the sale of security; minimum dividend pay-out to creditors; the disclosure and acceptance procedure; the rights of disputed claims to take part in the voting process and provisions for disputed claims to be resolved; and voting rights and powers of "insiders". Provision of this information supports the key objective of transparency and can assist in ensuring creditor confidence in the process. It may need to be balanced, however, against confidentiality concerns arising from creditor access to potentially sensitive financial and commercial information relating to the debtor, even where that information may ultimately enter the public domain through approval of the plan by a court.

273. The question of what is to be included in the plan is closely related to the question of approval and effect of the plan. The outcome of the plan rests on what is feasible, in other words whether, on the basis of known facts and circumstances and reasonable assumptions, the plan and the debtor are more likely than not to succeed. When voting on a plan, creditors need to be able to assure themselves that the plan is feasible and not based, for example, on faulty assumptions or leaves the debtor with overburdened with debt. To facilitate that evaluation, the plan can be accompanied by a report of a qualified professional who can be expected to provide a credible and unbiased view of the measures proposed by the plan. Where creditors do not agree with the professional evaluation, those views could be taken into account either in voting on the plan, by a mechanism allowing for amendment of the plan, or by the court when it confirms the plan (where that is a required element of the process).

274. Content of the plan also raises issues related to other laws. For example, to the extent that national company law precludes debt-for-equity conversions, a plan that provides for such a conversion could not be approved. Since debt-for-equity conversion can be an important feature of reorganization, it would be necessary to eliminate the prohibition if such provisions were to be included in a plan and approved. Similarly, if a plan is limited to debt forgiveness or the extension of maturity dates, it may not receive adequate support from creditors for it to be successful. Some insolvency cases raise similarly straightforward and uncontroversial issues of the relationship between the insolvency law and other laws. Other cases may raise more complicated questions. These may include limits on foreign investment and foreign exchange controls (especially in cases where many of the creditors are non-residents), or the treatment of employees under relevant employment laws where, for example, the reorganization may

raise questions of modification of collective bargaining agreements, or questions related to taxation law. Some insolvency laws allow certain limitations contained in other laws to be overruled in specified circumstances and it is desirable, in order to ensure transparency and predictability, that an insolvency law specifically address the question of its relationship with other laws.

(d) Approval and effect of the plan

275. Designing the law with regard to the approval and effect of the plan requires balancing of a number of competing considerations. On the one hand, it may be desirable to provide a way of imposing an agreed plan upon a minority of dissenting creditors in order to increase the chances of success of the reorganization. To the extent that a plan can be approved and enforced upon dissenting creditors, there may be a need to ensure that the content of the plan provides appropriate protection for dissenting creditors and, in particular, that their rights cannot be unfairly affected. On the other hand, to the extent that the approval procedure results in a significant impairment of creditors' claims without their consent (particularly secured creditors), there is a risk that the willingness of creditors to provide credit in the future may be undermined.

(i) Secured and priority claims

276. In many cases, secured claims will represent a significant portion of the value of the debt owed by the debtor and different approaches may be taken to the approval of the plan by secured and priority creditors. Under one approach, where the law ensures that an approved plan will not preclude secured creditors from exercising their rights, there is generally no need to give these creditors the right to vote since their interests will not be impaired by the plan. Priority creditors are in a similar position under this approach—the plan cannot impair the value of their claims and they are entitled to receive full payment. The limitation of this approach, however, is that it may reduce the chances for a successful reorganization, especially where the assets securing the claim are vital to the success of the plan—if a secured creditor is not bound by the plan or the plan provides for full satisfaction of the secured creditor's claims, the election by the secured creditor to exercise its rights may make the plan impossible to implement. Similarly, in certain circumstances, the only way in which the plan may succeed is to provide that priority creditors receive less than the full value of their claims upon approval of the plan.

277. To resolve some of these difficulties, some countries adopt the approach of allowing secured and priority creditors to vote as separate classes on a plan that would otherwise impair the value of their claims or to otherwise consent to be bound by the plan. The creation of these classes recognises that the respective rights and interests of these creditors differ from those of unsecured creditors. To the extent that majority support is obtained from both secured and priority classes of creditors, they will be bound by the terms of the plan. In these circumstances, laws generally require that dissenting creditors be entitled to receive at least as much as they would have received under liquidation. Some insolvency laws also provide that secured creditors may be bound by the plan where the court has the power to order that they are bound, provided it is satisfied as to certain conditions. These may include that enforcement of the security by the secured creditor will have a material adverse effect on achieving the purposes of the plan and that the security and interests of the secured creditor will be sufficiently protected under the plan.

(ii) General unsecured creditors

278. Even if voting by secured or priority creditors is not permitted, it is desirable that the general unsecured creditors have an effective means for voting on a plan. Different mechanisms may be used, but whichever is chosen it should be clearly set out in an insolvency law to ensure predictability and transparency.

279. *Majorities*. Some laws identify the minimum threshold of support required of general unsecured creditors in order make the plan binding on those creditors, as well as the voting procedures that are to be used to determine this support. One issue of importance is the manner in which votes are calculated, whether on the basis only of the percentage of value of the debt that supports the plan or also of the number of creditors that are supportive. Some laws require, for example, that the plan be supported by two-thirds of the value of the debt and one-half of the number of creditors. Other combinations are also used. Although increasing the difficulty of achieving approval, such a procedure may be justified on the basis that it protects the collective nature of the proceedings. For example, if a single creditor holds a majority of the value, such a rule prevents that creditor from imposing the plan on all other creditors against their will. Similarly, a large number of very small creditors cannot impose their decision on a few creditors who hold very large claims. That procedure may also be justified on the basis that it helps to ensure the support for the plan is sufficient to enable it to be successfully implemented.

280. With regard to voting procedures, many countries adopt the approach of calculating the percentage of support on the basis of those actually participating in the voting. Absentees are considered to have little interest in the proceedings. Such an approach requires adequate notice provisions and their effective implementation, especially where creditors are non-residents (see ...).

281. *Classes of creditors*. Some countries that have established classes for secured and priority creditors also provide for the division of unsecured creditors into different classes. The creation of these classes is designed to enhance the prospects of reorganization in at least three respects by providing: a useful means of identifying the varying economic interests of unsecured creditors; a framework for structuring the terms of the plan; and a means for the court to utilize the requisite majority support of one class to make the plan binding on other classes which do not support the plan. Since the creation of different classes has the potential to complicate the voting procedure, it may be desirable only where there are compelling reasons for special treatment of some unsecured creditors. Criteria that may be relevant in determining commonality of interest may include: the nature of the debts giving rise to the claims; the remedies available to the creditors in the absence of the reorganization plan and the extent to which the creditors could recover their claims by exercising those remedies; the treatment of the claims under the reorganization plan; and the extent to which the claims would be paid under the plan.

282. *"Cram-down" authority*. A few countries that provide for voting by secured and priority creditors and for the creation of different classes of unsecured creditors also include a mechanism that will enable the support of one class to make the plan binding on other classes (including classes of secured and priority creditors) without their consent. This is often referred to as a "cram-down" provision. The creation of classes and the application of such rules complicate both the insolvency law and its application by the insolvency representative and the court and may require for example, the exercise

of considerable discretion on economic matters, such as categorization by the court of unsecured creditors on the basis of their economic interests. This discretion, where it is not exercised in an informed, independent and predictable manner, has the potential to undermine creditor confidence.

283. *Shareholders*. Some laws provide for the approval of plans by shareholders of the debtor, at least where the corporate form, the capital structure or the membership of the debtor will be affected by the plan. In addition, where the debtor's management proposes a plan, the terms of the plan may already have been approved by the shareholders (depending upon the entity in question, this may be required under its constitutive instrument). This is often the case where the plan directly affects shareholders such as by providing for debt-for-equity conversions, either through the transfer of existing shares or the issuance of new shares.

284. In circumstances where the law permits creditors or an insolvency representative to propose a plan, and the plan contemplates debt-for-equity conversion, some countries allow the plan to be approved over the objection of shareholders, irrespective of the terms of the constitutive instrument of the entity. Such plans may result in existing shareholders being entirely displaced without their consent.

(iii) Related party creditors

285. [voting on approval of the plan]

(iv) Effect of the plan

286. Where the plan is approved, different approaches are taken to who is bound by it. Some insolvency laws appear to bind only those creditors who voted on the plan, while other laws appear to bind all unsecured creditors, directors and shareholders.

(e) Court confirmation of the plan

287. Not all countries require the court to confirm the plan approved by creditors; approval by a majority of creditors is all that is required. The court, however, may have role to play with regard to review of the plan where the plan itself or the means by which it was procured is challenged by minority creditors (see "Challenges to the plan").

288. Where the court (or in some countries an administrative authority) is required to confirm a plan, it would normally be expected to confirm a plan that has been approved by the requisite majority of creditors. Many countries enable the courts to play an active role in "binding in" creditors by making the plan enforceable upon a class of creditors that has not approved the plan. This may involve the court in undertaking a role that is in the nature of a legal formality; it does not require the court to examine the commercial basis upon which the plan was approved but to ensure that the decision of the creditors was properly obtained and that the necessary pre-conditions were satisfied. The court may reject the plan on the grounds that the interests of dissenting creditors have not been adequately protected (because, for example, they have not received as much as they would have received in liquidation), or there is evidence of fraud in the approval process.

289. Some insolvency laws also give the court the authority to reject a plan on the grounds that it is not feasible. This may be justified, for example, where secured creditors are not bound by the plan but the plan does not provide for full satisfaction of the secured claims of these creditors. The court may reject the plan in such a case if it considers that secured creditors will exercise their rights against the security, thus rendering the plan impossible to perform. The risk of this occurring can be addressed in provisions relating to preparation and approval of the plan. Whatever role the court is required to play in terms of the reorganization plan, it is desirable that it not be asked to review the economic and commercial basis of the decision of creditors unless it has the competence and experience to do so.

(f) Challenges to the plan

290. Since all creditors are likely to be prejudiced by reorganization proceedings, a level of prejudice or harm that exceeds the prejudice or harm suffered by other creditors or classes of creditors would generally be required to support a challenge to the plan. Some laws also provide that the plan should be subject to challenge, with provision for it to be reconsidered or set aside, by reference to established criteria against which the dissent of those creditors can be judged. Criteria may include that approval of the plan was obtained by fraud (such as that false or misleading information was given or material information was withheld with respect to the reorganization plan), or there was some irregularity in the voting procedure (such as that related person creditors participated, or that the resolution approving the plan was not consistent with the interests of creditors generally) or in the conduct of the meeting at which the vote was taken.

(g) Amendment of the plan

291. Where a vote on a reorganization plan fails to achieve the level required for the plan to be approved, an insolvency law may adopt a mechanism that could lead to amendment and reconsideration of the plan by creditors. One approach, for example, may be to allow a majority of creditors to vote to adjourn the decision meeting to enable further disclosure, if it appears that some further negotiation on a plan may produce a favourable result or to address unresolved disputes and issues. As with all areas of the process, however, it is desirable that that adjournment be available in limited circumstances or at least a limited number of times, with perhaps time limits being included to facilitate speedy resolution of the renegotiations and avoid abuse.

292. An insolvency law may also include provision for a plan to be amended after it has been approved if its implementation breaks down or it is found to be incapable of performance. Many jurisdictions provide for the plan to be amended if that is in the interests of creditors. Where the court has confirmed the original plan, it may also be required to confirm the amended plan.

(h) Implementation of the plan

293. Most plans can be executed without the need for further intervention. But sometimes it may be necessary for the implementation to be supervised or controlled by an independent person. Several countries provide that the court has an ongoing role in supervision of the debtor after approval and confirmation of the plan, pending completion of its implementation. This may be important where issues of interpretation of the performance or obligations of the debtor or others arise. Some countries permit

the court to authorize continued supervision of the affairs of the debtor, to varying degrees, by a supervisor or insolvency representative after the confirmation of the plan.

(i) Where the plan is not approved or implementation fails

294. In cases where a plan is not approved or implementation breaks down and in both of those cases amendment of the plan will not resolve these difficulties, an insolvency law may adopt different approaches as to what should occur. Some insolvency laws provide that the failure by creditors to approve the plan should be taken as an indication that they favour liquidation. This approach which may operate to encourage debtors to propose an acceptable plan, but it is desirable that it is subject to safeguards preventing abuse in cases where the support for liquidation is not in the interests of all creditors.

295. Where the implementation of the plan has broken down irretrievably, an insolvency law may provide for conversion to liquidation. Although that approach will provide some certainty as to an ultimate resolution of the proceedings, it may lead to further delay and diminution of value, with the result being of less value to creditors than a reorganization. A further approach may be to regard the insolvency proceedings as at an end and allow creditors to take individual actions. This approach does not resolve the financial difficulties of the debtor and could lead to a race for assets that the commencement of collective proceedings was intended to avoid. A compromise approach may be to allow the proposal of a different plan by creditors within a specified deadline and only in situations where no plan can be prepared would liquidation follow. It must be recognized that at some point the balance between achieving the best outcome for all creditors and achieving what is feasible tips in favour of pursuing what is feasible, and it is desirable that an insolvency law be sufficiently flexible to allow this to occur.

(j) Conversion to liquidation

296. A number of circumstances may arise in the course of a reorganization proceeding where it may be desirable for an insolvency law to provide a mechanism to convert the proceedings into liquidation. These circumstances may include where it is determined that there is no reasonable likelihood of the business being successfully rehabilitated or where it is apparent that the debtor is abusing the reorganization process either by not co-operating with the insolvency representative (e.g. withholding information) or otherwise acting in bad faith (e.g. fraudulent transfers). Because it is the party that, after the debtor or its management, has the greatest knowledge of the debtor's business, and so often learns at an early stage whether or not the debtor's business is viable, the insolvency representative can play a key role in the conversion process. In addition, it may be reasonable to allow creditors or the creditor committee (where one has been appointed), to request the court to convert the proceedings on similar grounds. The court could also be given the power to convert on its own motion.

297. Several approaches may be adopted to provide safeguards against abuse of the conversion procedure. One option may be to provide time limits for the completion of the reorganization procedure (e.g. 120 days from commencement) and that the court will not have the authority to extend that period. This approach may have the advantage of establishing a deadline that acts as a catalyst for the preparation and approval of the plan, although it could also run the risk of imposing arbitrary constraints that may prove to be unnecessary or unwarranted in certain cases (such as very large insolvencies where preparation of the plan may take more than 12 months) and may lead to the failure of an otherwise successful reorganization because of the inflexibility of the deadline. A

variation of that approach that would give greater leverage to creditors may be to establish an initial time period (perhaps 60-90 days) that could be extended only by a vote of the creditors (perhaps on the basis of a report by the insolvency representative or an independent expert regarding the feasibility of reorganization) but which, in any event, could not exceed an outside limit (e.g.120 days).

(k) Discharge of debts and claims

298. To ensure that the reorganized entity has the best chance of succeeding, an insolvency law can provide for a discharge or alteration of debts and claims that have been discharged or otherwise altered under the plan. This approach supports the goal of commercial certainty by giving binding effect to the forgiveness, cancellation or alteration of debts in accordance with the approved plan. The principle is particularly important to ensure that the plan provisions will be complied with by creditors that rejected the plan and by creditors that did not participate in the process. It also gives certainty to other lenders and investors that they will not be involved in unanticipated liquidation or have to compete with hidden or undisclosed claims. Thus the discharge establishes unequivocally that the plan fully addresses the legal rights of creditors.

(l) Termination of the plan

299. A reorganization plan would normally be treated as terminated where it had been fully implemented or where the court orders it be terminated because of a failure of implementation. In the latter case, in order to avoid the debtor being left in an insolvent state with its financial situation unresolved, the court may also make an order for the proceedings to be converted to liquidation.

2. Summary and recommendations—reorganization plans

(1) The purpose of provisions relating to the reorganization plan is to:

(a) to facilitate negotiations between the debtor, its creditors and other interested parties for the purpose of dealing with the financial difficulties of the debtor under a plan of reorganization;
(b) to bind all creditors and the debtor to the plan of reorganization;
(c) to provide for the implementation of the plan of reorganization;
(d) to address the consequences of a failure to propose an acceptable plan, inability to have the plan approved by creditors, failure of implementation of the plan;
(e) to convert the proceedings to liquidation in certain circumstances;
(f) to discharge debts and claims.

(2) A reorganization plan may be proposed upon filing of an application for insolvency proceeding or after commencement of the insolvency proceeding. Where the reorganization plan is required on filing of the application it would be prepared by the debtor.

(3) Where the reorganization plan is to be formulated after commencement of proceedings, an insolvency law should adopt a flexible approach to formulation of the plan that potentially involves all parties central to the insolvency proceedings – the debtor, the creditors and the insolvency representative. For example, it could

provide that the debtor be given an exclusive period to propose a plan, but should consult with creditors and the insolvency representative in so doing. After the expiration of that exclusive period, if the debtor has not been able to propose an acceptable plan, one or more creditors or the creditor committee, in consultation with the insolvency representative, or the insolvency representative itself could be given the opportunity to propose a plan.

(4) The insolvency law may specify the minimum contents of a reorganization plan, taking into account the provisions of other relevant laws. This could include [*statements as to the financial situation of the debtor including asset and liability and cash flow statements; details of the precise proposals included in the plan; details of what creditors would receive (and how that would be more than they would otherwise receive in liquidation); and the basis upon which the business would be able to keep trading and could be successfully reorganized*].

(5) For the purposes of a reorganization plan, creditors may be divided into classes according to the nature and content of their respective rights.

(6) A reorganization plan can be approved if it is supported by:

(a) the majority of classes of priority and secured creditors (where their rights are affected by the proposed plan);
(b) the majority of classes of unsecured creditors; and
(c) the majority of the shareholders of the debtor (when their rights are affected by the proposed plan).

(7) For the purposes of approval, a majority shall be one-half of the number of creditors that actually vote and two-thirds of the debt respectively held by them.

(8) The insolvency law may provide that approval of the reorganization plan by a majority of creditors will make the plan binding on dissenting creditors ("cram-down provision").

(9) An insolvency law may provide for confirmation of the reorganization plan by a court or relevant administrative body in order to make it enforceable against creditors. The court may have the power to confirm the plan provided that:

(a) the interests of dissenting creditors are adequately protected;
(b) the plan is feasible;
(c) [*other*].

(10) Dissenting creditors can object to the plan on the basis that approval of the plan was obtained by fraud (such as that false or misleading information was given or material information was withheld with respect to the reorganization plan), or there was some irregularity in the voting procedure (such as that related person creditors participated, or that the resolution approving the plan was not consistent with the interests of creditors generally).

(11) The court should have the power to supervise the implementation of the plan or to authorize supervision by a supervisor or insolvency representative, where this is necessary.

(12) Provision should be made for the plan to be amended when it fails to achieve the level of support required for approval, or after approval, on the basis that implementation of the plan breaks down or the plan is found to be incapable of implementation.

(13) The insolvency law should address the issue of discharge of the debts and claims on the basis of the manner in which they are treated in the reorganization plan.

(14) The insolvency law should provide for termination of the plan when implementation has been completed or, where implementation fails and the plan cannot be amended, for the proceedings to be converted to liquidation.